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American Institute of Certified Public Accountants. Task Force on Discounting Applications

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THE USE OF DISCOUNTING IN FINANCIAL REPORTING FOR MONETARY ITEMS WITH UNCERTAIN TERMS OTHER THAN THOSE COVERED BY EXISTING AUTHORITATIVE LITERATURE

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NOTE

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THE USE OF DISCOUNTING IN FINANCIAL REPORTING FOR MONETARY ITEMS WITH UNCERTAIN TERMS OTHER THAN THOSE COVERED BY EXISTING AUTHORITATIVE LITERATURE

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INTRODUCTION

Background and Approach

1. The Accounting Standards Executive Committee (AcSEC) established the Task Force on Discounting Applications (task force) in 1985 with this charge: "To identify and analyze issues on the use and application of discounting in financial reporting, focusing on the specific areas of the insurance industry, rate regulated industries, impairment of value and income taxes."

2. The reasons the task force was established include the following:

a. Some believe that certain financial statement items that presently are recorded at absolute amounts should reflect the time value of money and the current financial reporting for those items should be reexamined.

b. The FASB has indicated that without a broader investigation of the applicability of discounting to financial reporting in general, it generally is reluctant to impose the requirement to discount amounts recorded in the financial statements beyond those areas in which discounting already is required. That position was stated, for example, in the

proposed Statement of Financial Accounting Standards, "Accounting for Income Taxes."

c. AcSEC has prepared issues papers that contain advisory conclusions to discount (for example, "Discounting Claims of Insurance Enterprises") but those documents have not been issued as final because of the lack of general guidance relating to discounting.

d. In recent years, unusually high interest rates have caused the materiality of the effects of not discounting to increase significantly.

e. Some believe the sophistication of the preparers and users of financial statements has increased regarding the mechanics and results of discounting. Discounting is contained in college curricula of accounting and finance courses and the accounting literature has increasingly embraced the concept.

f. Some perceive that practice is changing for writedowns due to an impairment of value. Articles appearing in the financial press indicate there recently has been a dramatic increase in the number of writedowns due to an impairment of value. Some of these writedowns were based on computations incorporating discounting while others either ignored discounting or were based on methods that did not rely

on discounting. Practitioners increasingly are faced with the prospect of reporting on the results of writedowns based on sparse accounting literature on that subject. As a result, some have asked for guidance from the FASB, including AcSEC, which sent the FASB an issues paper, "Accounting for the Inability to Fully Recover the Carrying Amounts of Long Lived Assets." Any final pronouncement on the appropriate manner to calculate a writedown relating to impairments of value must address discounting.

3. Authoritative accounting literature already addresses the use and application of discounting in certain areas of financial reporting. For example, APB Opinion No. 21, "Interest on Receivables and Payables," addresses all receivables and payables that represent contractual rights to receive money or contractual obligations to pay money on fixed or determinable dates, regardless of whether there is any stated provision for interest, except for (1) specifically exempted items listed in paragraphs 3 and 4 of that Opinion (see Appendix A of this paper) and (2) items specifically covered by other accounting literature covered by Rule 203 of the AICPA Code of Ethics (for example, troubled debt restructurings under FASB Statement No. 15).

4. The existing accounting literature does not address specifically the application of discounting to the items on which the task force was asked to focus. The task force perceived that the four items it was asked to address fall within two categories -- monetary items whose amounts and/or timing of future cash flows are uncertain (that is, loss reserves of property/casualty insurance enterprises and deferred income taxes), and impairments of value, which included issues related to rate regulated industries. Since the task force was formed, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 90, "Regulated Enterprises - Accounting for Abandonments and Disallowances of Plant Costs," that addresses the application of discounting in accounting for abandonments and disallowances of plant costs. This issues paper, therefore, does not focus on impairment of value issues related to rate regulated industries.

5. The ultimate objective of this issues paper is to provide input to the FASB for its future consideration of the use and application of discounting in financial reporting. Accordingly, the task force decided that in order to approach discounting in as general a manner as possible and to focus consistently on loss reserves of property/casualty insurance enterprises and deferred income taxes, it should develop

concepts underlying the application of discounting to the broad category of monetary items with uncertain terms. The first section of this paper addresses concepts of discounting as they relate to monetary items with uncertain terms, as defined in paragraph 7. A second section that would apply those concepts to insurance loss reserves of property/casualty insurance enterprises and deferred income taxes has not been completed.

6. The issue of measuring and recording impairments of value may involve the need to discount an estimated amount of money to be received or paid in the future, but the focus is on whether amounts already recorded should be reduced by charges to income. In addition, the accounting literature has not defined precisely the concept of impairment of value -- possibly making the first step in this issue one of defining the attribute to be measured. As a result, a third section of this issues paper that would be devoted to the issue of impairment of value has not been completed at this point.

SECTION I -- CONCEPTS OF DISCOUNTING

ACCOUNTING FOR MONETARY ITEMS WITH UNCERTAIN TERMS

Scope and Definition of Monetary Items With Uncertain Terms

7. The issues and advisory conclusions in this section apply to "monetary assets or liabilities (items) with uncertain terms" defined for the purposes of this paper as: assets or liabilities currently recorded on the balance sheet that involve the right to receive or the obligation to pay money in the future and whose amounts and/or timing of future cash flows are uncertain. The concepts section of this paper does not apply to those items specifically covered by existing authoritative accounting literature (for example, leases under FASB Statement No. 13, as interpreted and amended, or troubled debt restructurings under FASB Statement No. 15). It also does not apply to those items specifically exempted in paragraph 3 of APB 21, except for assets and liabilities described in item C. of that paragraph (that is, this section does apply to security deposits, retainages on contracts and other amounts intended to provide security for one party to an agreement). In addition, the concepts section does not apply to a nonmonetary asset or liability recorded on the balance sheet, for example, in a business combination using the present value of future cash flows as the measurement attribute.

Recognition Criteria

8. FASB Statement of Financial Accounting Concepts No. 5 (SFAC 5) lists four fundamental recognition criteria:

a. Definitions -- The item meets the definition of an element of financial statements.

b. Measurability --It has a relevant attribute measurable with sufficient reliability.

c. Relevance --The information about it is capable of making a difference in user decisions.

d. Reliability --The information is representationally faithful, verifiable and neutral.

9. The task force believes it need not address whether monetary items with uncertain terms meet the definition of an element of financial statements. The items covered by this paper are accepted as meeting this definition because they are currently recorded on the balance sheet.

10. The task force also believes the primary consideration in addressing discounting is whether the process of discounting yields a relevant attribute measurable with sufficient reliability. That is, is the information capable of making a difference in user decisions and is it representationally faithful, verifiable and neutral?

Measurement Attributes and Discounting

11. Items currently reported in financial statements are measured by different attributes depending on the nature of the item and the relevance and reliability of the attribute measured. In SFAC 5, the Board expects the use of different attributes to continue and lists five different attributes of assets and liabilities used in practice:

a. Historical cost (historical proceeds)

b. Current cost

c. Current market value

d. Net realizable (settlement) value

e. Present (or discounted) value of future cash flows.

SFAC No. 5 goes on to state that amounts initially recorded for trade receivables and long-term notes payable generally fit the historical exchange price description. However, some assets are acquired, and some liabilities are incurred, without exchanges (for example, assets found or donated and income tax or litigation liabilities). Since there is no historical exchange price in those situations, some other attribute must be used.

12. The Accounting Principles Board concluded in APB 21 that the present value of future cash flows is the relevant measurement attribute for those items covered by that Opinion in the absence of (1) established exchange prices for the property, goods or service or (2) evidence of the market value of the note. In determining an appropriate discount rate, APB 21 states "[t]he objective is to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the

purchase which bears the prevailing rate of interest to maturity." APB 21 indicates that "unless the note is recorded at its present value... the sales price and profit to a seller in the year of the transaction and purchase price and cost to the buyer are misstated, and interest income and interest expense in subsequent periods are also misstated." The Opinion also states that "a note exchanged for property, goods or service represents two elements...(1) the principal amount, equivalent to the bargained exchange price...and (2) an interest factor to compensate the supplier over the life of the note for the use of funds he would have received in a cash transaction at the time of the exchange. Notes so exchanged are accordingly valued and accounted for at the present value of the consideration exchanged...."

13. Discounting techniques are clearly not foreign to accounting as it is practiced today. Applications of discounting in practice include:

> Notes Receivable and Payable -- Measuring the amount to be recorded initially for receivables and payables that have no stated interest rate or whose interest rate is different from the market rate, in the absence of established exchange prices for the related property, goods or service or evidence of the market value of the note.

Leases -- Measuring the initial value of assets to be recorded under long-term leases and measuring the amount of lease payments and amortization of leaseholds.

Business Combinations -- Measuring the initial value of receivables, payables, liabilities, accruals, and commitments acquired or assumed in a purchase business combination. Measuring the consideration given if the consideration is in the form of long-term liabilities.

Capital Assets -- Measuring the initial value of assets acquired under deferred payment contracts.

Pensions -- Measuring the actuarially computed value of the obligation to provide future pension benefits.

Insurance Reserves -- Measuring the actuarially computed value of certain future policy and claim liabilities of insurance enterprises.

Capitalized Costs -- Measuring the value of future net revenues from estimated production of oil and gas reserves to be included in the full cost ceiling test.

14. Admittedly, those examples do not encompass all examples of the use of discounting in the current accounting literature. In fact, a NAARS search of the accounting literature revealed many references to circumstances in which the concepts of discounting are used. Appendix B of this paper summarizes those citations. The common characteristic that exists in all instances in which discounting currently is used in accounting practice is that the present value of future cash flows is considered the relevant attribute, or a surrogate therefor, in determining the amount to be initially recorded in the financial statements.

15. The strength of the evidence in existing accounting literature that the concepts of discounting and the time value of money should be considered in recording transactions that involve the right to receive or the obligation to pay money in the future does not necessarily mean that those concepts should be used when recording the items encompassed by this issues paper. As previously stated, the attribute used depends on the nature of the event and the relevance and reliability of the attribute measured. In other words, whether discounting is appropriate in a particular situation depends on whether (1) the result of the calculation is capable of making a difference in user decisions and (2) the factors needed to apply the

calculation are determinable with sufficient reliability to be included in the financial statements. The gross amount of cash to be received or paid, the timing of cash to be received or paid, and an appropriate rate of interest must be known or reliably estimable to discount items reported in the financial statements.

16. Therefore, the threshold issue is whether the present value of future cash flows is the most relevant attribute for the initial recognition and measurement of monetary items with uncertain terms covered by the scope of this paper.

INITIAL RECOGNITION OF MONETARY ITEM WITH UNCERTAIN TERMS

Issue 1 -- Is the present value of future cash flows the most relevant measurement attribute for initial recognition of those monetary items with uncertain terms included within the scope of this paper?

Arguments For

17. SFAC 5 states that different measurement attributes are used in practice and long-term receivables and payables are reported at their present value (that is, discounted value of future cash flows). Proponents of discounting believe

reflecting the time value of money in the initial recognition of monetary items with uncertain terms records the monetary value of the event today and results in financial statements that better reflect the economics of the business. They point out a dollar of cash on hand today is worth more than a dollar of cash to be received in the future and believe financial statements of an entity should contain the assets and liabilities that are recorded initially in a manner reflecting that relationship.

18. Proponents also argue that some users of financial statements, in decision making, already implicitly discount amounts reported on an undiscounted basis, if they know or can estimate the timing of cash flows and the appropriate discount rate. As an example, some investors in decision making may implicitly discount recorded amounts when they purchase or sell an entity's stock at amounts different from book value. Initially recording a monetary item with uncertain terms at its present value (that is, explicit discounting) makes implicit discounting unnecessary.

19. Proponents also believe preparers of financial statements often implicitly consider the time value of money when estimating the amounts to be initially recorded. For example, insurance enterprises that estimate the ultimate cost

of claims to be presented on their balance sheets, in fact, may sometimes implicitly recognize the time value of money. Life and health insurance enterprises generally explicitly discount long-term claim liabilities, and recently some other insurance enterprises have recorded claim liabilities at discounted ultimate cost, either initially or when claim liabilities are purchased from a third party and the purchase price reflects the time value of money. Explicit discounting of such liabilities formalizes the discounting process and reflects the economics underlying the event.

20. Both APB 21 and APB Opinion No. 16 (APB 16), "Business Combinations," conclude fair value is the most relevant attribute for recording receivables and liabilities covered by those Opinions, and discounted or present value often is used as a surrogate for fair value. These pronouncements have been in existence for more than a decade and users and preparers of financial statements have accepted reporting long-term receivables and liabilities at their discounted or present values.

21. If future price changes are considered in estimating the ultimate amounts of cash flow, some believe it is inconsistent to both (1) consider the anticipated effects of future price changes and (2) ignore the offsetting effect of

the time value of money when initially recording a monetary item with uncertain terms in the financial statements.

22. Many rights to receive or obligations to pay money can be sold to or assumed by a third party at an amount less than the ultimate amount. The negotiated price (settlement value) always reflects the time value of money either explicitly or implicitly. Some believe the inability to settle with a current cash payment (for example, deferred income tax liabilities) does not preclude the use of discounting. An entity that defers the payment of income taxes is able to retain those amounts for its use until needed for payment in the future (that is, the delay creates an economic benefit to the entity).

23. Some believe recording a liability based on estimates, rather than fixed or determinable amounts, at ultimate cost without discounting (that is, using a zero rate of interest) is overly conservative and unrealistic. Likewise, they believe recording a receivable based on estimates, rather than fixed or determinable amounts, at an undiscounted amount is not conservative and is unrealistic. Estimates currently are required in financial statements in many areas and measurement of some amounts requires discounting (for example, leases, pension costs).

Arguments Against

24. Opponents of discounting believe reflecting the time value of money in the initial recognition of monetary items with uncertain terms may not result in reporting the most relevant attribute (that is, it may not be relevant for users to know the separate elements of principal and interest). They point out APB 21 concluded the most relevant attribute is an established exchange price (either the fair value of the property, goods or services or the market value of the note) and discounting is only a surrogate when fair or market values are not determinable. Also, APB 21 is transaction-oriented and many monetary items with uncertain terms are not recorded initially in the financial statements as the result of transactions. Some believe that when initially recording an item the undiscounted amount is the relevant attribute, particularly when the payment date or pattern can be determined by the user of the financial statements (for example, through disclosure in the notes to the financial statements or otherwise).

25. Some point out that future price changes often are explicitly excluded when determining the ultimate amounts of cash flows and as such, recorded amounts may reflect an implicit recognition of the time value of money. Therefore, recording those amounts at present value (that is, explicit

discounting) would, in effect, double-count the time value of money unless the future price changes are considered.

26. Some believe it is inappropriate to consider the time value of money when the amount cannot be settled at less than the ultimate amount in a current cash exchange with the opposite party. For example, deferred income tax liabilities normally cannot be directly settled currently at less than the ultimate amount.

27. Opponents of discounting point out that certain authoritative accounting literature proscribes discounting in some circumstances (for example, accounting by debtors and creditors for troubled debt restructurings -- FASB 15). They believe regardless of the increased sophistication of users, many still do not understand the concept of discounting and its results.

28. Some believe discounting would require the development of measurement techniques that would increase the difficulty inherent in an estimation process that already involves other substantial uncertainties and imprecisions. Requiring the use of discounting in the initial recognition of monetary items with uncertain terms would be a major change in practice and may not be understood by financial statement users.

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Advisory Conclusion (Issue 1) -- AcSEC believes (13 yes, 2 no) and all five task force members believe that the present value of future cash flows is the most relevant measurement attribute for the initial recognition of the monetary items with uncertain terms included within the scope of this paper.

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Issue 2 -- Assuming the present value of future cash flows is the most relevant measurement attribute for the initial recognition of monetary items with uncertain terms, should discounting be applied in the initial recognition of those items when the amounts and timing of cash flows are reasonably estimable?

Discussion

29. FASB Statement of Financial Accounting Concepts No. 2 states that "reliability of a measure rests on the faithfulness with which it represents what it purports to represent, coupled with an assurance for the user, which comes through verification, that it has that representational quality."

Information provided by financial reporting often results from approximate, rather than exact, measures involving numerous estimates, including the amounts and timing of cash flows. The task force has identified the following combinations:

a. Amounts and timing of cash flows are fixed or determinable (for example, notes receivable or payable).

b. Amounts of cash flows are fixed or determinable; timing is not fixed or determinable.

- On an individual basis (for example, a deferred compensation obligation to an individual upon retirement -- timing usually is estimated based on mortality tables).

- On a group basis (for example, the liability for future policy benefits of life insurance enterprises - the payment pattern is not determinable on an individual basis, but in the aggregate can be reasonably estimated).

c. Timing of cash flows is fixed or determinable; amounts are not fixed or determinable.

- On an individual basis (for example, the amount of a note receivable is fixed - principal payments are due quarterly contingent upon earnings levels of the entity sold).

- On a group basis (for example, contractual termination benefits provided to employees in the event of a plant closing - the amount is not determinable on an individual basis but can be reasonably estimated on a group basis).

d. Both amounts and timing of cash flows are not fixed or determinable.

- On an individual basis (for example, litigation liabilities).

- On a group basis (for example, property and casualty claim liabilities).

Arguments For

30. Some believe discounting can be applied when the amounts and timing of cash flows can be reasonably estimated, either on an individual basis or in the aggregate. They believe if an item has been recognized in the financial statements, the reliability criterion has been met for that item as to amount. (This issues paper addresses only items already recorded under current generally accepted accounting principles. Therefore, initially recording a gain contingency is not an issue.) To assert that discounting cannot be applied challenges the conclusion that the amount was sufficiently reliable to record initially. Those who support this view point out that the amounts and timing of pension liabilities, for example, are not fixed or determinable, but are based on actuarial assumptions and discounted. In addition, some insurance enterprises with certain long-duration contracts believe the results of discounting are sufficiently reliable to support its use in the initial recognition of the related liabilities. As a further indication of this reliability, insurance loss reserves have been purchased by independent third parties with the purchase price reflecting the time value of money.

Arguments Against

31. While this paper focuses on monetary items with uncertain terms, some believe present value concepts should be applied only when the amounts and timing of cash flows are fixed or determinable. Those who support this view believe that only those items meet the criteria of APB 21. They believe amounts and payment patterns that are not fixed or determinable on an individual basis are imprecise estimates and discounting may connote a greater degree of precision which could be unfounded or potentially misleading. Amounts and payment patterns that are estimated on a group basis may be subject to differing degrees of variability and because of those variations, verifiability or representational faithfulness (components of reliability) diminish.

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Advisory Conclusion (Issue 2) -- AcSEC and the task force unanimously believe that discounting should be applied in the initial recognition of monetary items with uncertain terms when the amounts and timing of cash flows are reasonably estimable.

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Issue 2A -- If a range of timing of cash flows is known or reasonably estimable, should the discounting calculation use the shortest, longest or some other period of time within that range?

Discussion

32. Sometimes, it may be difficult to reasonably estimate the amounts or payment pattern of future cash flows due to uncertainties inherent in the item being measured. When monetary items with uncertain terms are reported in the financial statements (for example, insurance reserves and accruals for loss contingencies), the amount or a range of amounts are reasonably estimable.

33. Even if a range of amounts can be reasonably estimated, sometimes no single amount within that range is a better estimate than any other amount within the range. With respect to loss contingencies, FASB Interpretation No. 14 (FIN 14) requires the minimum amount in the range to be recorded. If a single amount within that range appears to be a better estimate, that amount must be recorded. Issue 2 above deals with discounting uncertain amounts initially recorded in the financial statements, including amounts accrued in accordance with FIN 14.

34. This issue deals with monetary items with uncertain terms recognized in the financial statements for which the payment dates of future cash flows are not known or reasonably estimable. When the payment dates are not reasonably estimable, a range of payment dates generally exists that would be reasonably estimable. For example, suppose no payment is expected after two years from today, but the payment date is not determinable. The range would consist of the period from today through two years from today. Discounting still may be appropriate when a range of timing of cash flows is known or reasonably estimable.

35. In some situations, the payment dates of future cash flows are within the control of the company and the payments are not intended to be made in the foreseeable future. A range of timing of cash flows generally is not reasonably estimable because the latest date (or period) within the range is not known or reasonably estimable. For example, suppose a company determines that payments will not be made for at least 20 years but cannot reasonably estimate any payment dates after 20 years. Some believe the payments dates in this situation are not reasonably estimable and discounting should not be applied. Others believe the company should estimate the earliest date (or period) the payments would be made and would require that date (or period) to be used in the discounting calculation. In the example, the company would use the earliest date (that is, 20 years) to discount the expected cash payments. They believe discounting should not be prohibited in

these situations just because the latest date (or period) within a range cannot be reasonably estimated.

36. If the estimate of the payment date (or period) is a range and no date (or period) within that range is more likely than any other, the present value calculation can be based on several alternatives as follows:

- Earliest date or shortest time period within that range.
- Latest date or longest time period within that range.
- Some other date or time period within that range (for example, average [mean] date within that range).

Liabilities

37. To illustrate: Company A estimates it will settle a lawsuit for $100,000 and records the liability and a loss on December 31, 19X5. The company is uncertain when the payment will be made and estimates a range of payment dates: from December 31, 19X6 through December 31, 19X9. No payment date within this range is more likely than any other.

38. Some believe the latest date (December 31, 19X9) should be used because this would cause the smallest loss to be recorded initially. They believe this is consistent with the notion of recording the minimum amount in the range (that is, smallest loss) contained in FIN 14. That Interpretation states, "Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount."

39. Others believe the earliest date (December 31, 19X6) should be used because this would produce the largest loss, which is more conservative. Recording a smaller loss today, by using a later payment date not more likely to occur, may defer losses to the future. For example, if the loss is recorded initially on December 31, 19X5 assuming a December 31, 19X9 payment date, and subsequently, the payment is made on December 31, 19X8, an additional loss would be recorded. They also believe since no payment date is more likely than any other, the liability should be reported at ultimate cost when the balance sheet date is within the estimated range of payment dates. Reporting the liability of $100,000 at December 31, 19X6, is more relevant than reporting a lesser discounted amount at that date. In addition, they point out that FIN 14 does not address discounting and should not be considered here.

40. Some believe the average (mean) date should be used because this would result in the "least wrong" reported liability on the average. If the latest date was used (December 31, 19X9) and an earlier payment was made, the initially recorded liability and loss would have been understated. If the earliest date was used (December 31, 19X6) and a later payment was made, the initially recorded liability and loss would have been overstated. On the average, the misstatement of the initially recorded liability and loss is minimized if a mean date is used (June 30, 19X7). The overriding concept is not conservatism, but to obtain the best (that is, the "least wrong") estimate of the liability and loss on the average. Others would use the average (mean) date only when discounting a group or portfolio of monetary items with uncertain terms.

41. Some believe any payment date within the range, although arbitrary, would be acceptable.

Assets

42. To illustrate: Company B sells its two-year-old high-technology subsidiary to an independent third party for $100,000 cash and a $50,000 note receivable. The sale is recorded on December 31, 19X1. The receivable bears no stated interest rate and is due on December 31 of the first year the

former subsidiary has net sales that exceed $5 million. If the former subsidiary's net sales never exceed $5 million, the payment is due no later than December 31, 19X9. No receipt date is more likely than any other.

43. When calculating the present value of amounts to be received, some believe that the latest date (December 31, 19X9) should be used as this would produce the most conservative result (that is, smallest gain recorded initially). The difference between the largest gain (that is, using December 31, 19X2) and the smallest gain is considered a gain contingency that should not be recognized until realized.

44. Others believe the earliest date should be used. Since no receipt date is more likely than any other, the receivable should be reported at the ultimate amount when the balance sheet date is within the estimated range of receipt dates. Reporting the receivable of $50,000 at December 31, 19X2, is more relevant than reporting a lesser discounted amount at that date.

45. Some believe the average (mean) date should be used because this would result in the "least wrong" reported asset on the average. Generally, the same arguments apply here as presented for liabilities (see previous comments). Others would use the average (mean) date only when discounting a group or portfolio of monetary items with uncertain terms.

46. Some believe any receipt date within the range, although arbitrary, would be acceptable.

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Advisory Conclusion (Issue 2A) -- AcSEC and the task force unanimously believe that if a range of timing of cash flows is known or reasonably estimable, the most likely date (or period) within that range should be used to compute the present value of future cash flows.

If no date (or period) within the range is more likely than any other and there is a single monetary item with uncertain terms being discounted, members of AcSEC and the task force believe that the following date (or period) within that range should be used:

	Liabilities		Assets	
	AcSEC	Task Force	AcSEC	Task Force
• Earliest date or shortest time period	11(A)	4(A)	0	0
• Latest date or longest time period	0	0	11(A)	4(A)
• Average (mean) date or period	4(B)	1(B)	4(B)	1(B)

However, when discounting a large group (or portfolio) of similar monetary items with uncertain terms and no date (or period) within the range is more likely than any other for the group of items, members of AcSEC and the task force believe that the following dates (or period) within that range for the group of items should be used:

	Liabilities		Assets	
	AcSEC	Task Force	AcSEC	Task Force
• Earliest dates or shortest time period	6(A)	4(A)	0	0
• Latest dates or longest time period	0	0	6(A)	4(A)
• Average (mean) dates or period	9(B)	1(B)	9(B)	1(B)

NOTES - (A) Members voted for the earliest date (or period) for liabilities and the latest date (or period) for assets because the use of those dates (or periods) produces the most conservative result.

(B) Members voted for the mean date (or period) because that date (or period) results in the "least wrong" initially recorded amount on the average.

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SELECTION OF THE DISCOUNT RATE AT INITIAL RECORDING

Issue 3 -- What discount rate(s) should be used to determine the present value of future cash flows in the initial recognition of monetary items with uncertain terms?

Objectives

47. Differing views exist as to the objectives of determining the present value of future cash flows, which may lead to differing views regarding the appropriate discount rate to be used:

- Some believe the objective of discounting is to record the monetary item with uncertain terms initially at fair value. They support the objective stated in APB 21, "to approximate the rate which would have resulted if an independent borrower and an independent lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity." When a cash exchange price is not determinable, the present value of future cash flows computed using an appropriate discount rate is a surrogate for the exchange price or fair value. They point out fair values are used to initially record

assets and liabilities in nonmonetary transactions, purchase business combinations and transactions covered by APB 21, and support this concept when initially recording items included within the scope of this paper.

Others believe the purpose of discounting is to present (1) assets at their present values determined without regard to the entity's borrowed funds used to finance the assets and (2) liabilities at their present values determined without regard to the entity's invested assets retained as a result of the delayed payments. The believe fair value is not a relevent attribute, particularly when the monetary item with uncertain terms cannot be settled or sold currently. Instead, they believe the objective of discounting is to record initially the economic gain or loss of the event that results in the recognition of the monetary item with uncertain terms. For example, some would measure an economic loss as the sum of money that, if invested currently in a hypothetical fund, would generate the necessary cash flows to settle the monetary liability with uncertain terms in the future.

- Others believe an objective of discounting is to achieve a matching of all elements of income and expense through the matching of the discount rate and actual rate of return on investments or actual borrowing rate, as applicable. The present value of a liability should equal an amount which, when compounded by an expected rate of return on invested assets, equals the ultimate amount of the liability at the estimated payment date. Likewise, the present value of an asset (receivable) should equal an amount which, when compounded by an expected interest rate on borrowings used to finance the asset, equals the ultimate amount of the receivable at the estimated receipt date. In periods subsequent to the initial recognition of the monetary item with uncertain terms, the accretion of this present value amount would match the related investment income or interest expense, as applicable. They point out FASB Statement No. 60 (FASB 60), "Accounting and Reporting by Insurance Enterprises," states, "Interest assumptions used in estimating the liability for future policy benefits shall be based on estimates of investment yields (net of related investment expenses) expected at the time contracts are made ....," and they support this concept in other situations.

- Others generally agree with the previously stated notion of matching elements of income and expense through the matching of rates. They believe, however, that cash is a commodity that is intrinsically of more value if available today than if merely deliverable at some future date. This intertemporal relationship is represented by the risk-free rate of interest, which when combined with management's expertise, or lack thereof, derives a return to its owner. This return is comprised of value for use of capital and profit for risk compensation.[1]

  Therefore, they believe the objective of discounting is to properly reflect the intrinsic time value of money absent the anticipated impact of management's risk taking activities designed to generate a profit from the use of the money. They believe that when assets are invested in other than risk-free investments, the risk-related portion of the investment income (or loss) should not be anticipated at the initial recognition of the monetary item with

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[1] The owner of cash could elect to purchase a consumable product or service, or he can invest it as capital, thereby deferring his ability to consume. The value given to encourage the owner of cash to defer his consumption reflects the time value of money. Additional value given to encourage an owner of cash to risk losing it is his profit for risk assumption.

uncertain terms. Therefore, the present value of a liability should equal an amount which, when compounded by a risk-free rate of return on invested assets, equals the ultimate amount of the liability at the estimated payment date. Those entities that accept risk when investing assets should recognize the risk-related portion of the rate of return when earned or lost.

- Still others believe the choice of the objectives above depends on the nature of the item being measured. Some argue that an investment rate should be used to discount insurance reserves while a borrowing rate should be used to discount income tax liabilities, each having a different objective. Others believe different objectives exist depending on whether the item can be settled or sold currently in a cash transaction.

Alternative Discount Rates

48. The task force identified the following types of rates that could be used when discounting a monetary item with uncertain terms:

a. Borrowing rates (long-term, short-term)

- Opportunity rate - Rate at which the entity can obtain unsecured debt financing for a similar term from other independent sources at the date the monetary item with uncertain terms is recorded (sometimes referred to as the "marginal" rate or incremental borrowing rate).

- Actual (imbedded) rate - Rate on existing borrowings of the entity at the date the monetary item with uncertain terms is recorded.

b. Investment rates (long-term, short-term; risk free, risk related)

- Opportunity rate - Rate of return that the entity can earn on investments for a similar term from other independent sources at the date the monetary item with uncertain terms is recorded. This rate can vary significantly depending on the level of risk the entity is willing to accept in the future (for example, a U.S. treasury bond versus a corporate equity security). The rate also can vary depending on the expected amount of reinvestment earnings, if any.

- Actual (imbedded) rate - Rate of return on existing assets of the entity at the date the monetary item with uncertain terms is recorded. This rate is a function of the level of risk the entity has accepted in making past investment decisions. The rate can vary significantly depending on the type of invested assets used to determine the rate. For example, when discounting liabilities, the rate may be one of the following:

  1. the expected yield on long-term fixed-income investments made during the past year, with maturities not extending beyond the maturity of the liability,

  2. the expected yield on existing fixed-income investments that have the same approximate term as the liability,

  3. the actual rate of return on all existing assets (including property, plant and equipment) held during the past year.

  4. the rate used by insurance enterprises in determining the liability for future

policy benefits in accordance with FASB 60.

c. Settlement rate - The rate at which a monetary liability with uncertain terms can be settled or a monetary asset (receivable) with uncertain terms can be sold. Several sources may be available to determine the best estimate of the settlement rate, including the following:

- If the monetary item with uncertain terms is recorded as the result of an exchange and the exchange price is objectively determinable, the settlement rate is the rate necessary to compensate the party for the use of funds that party would have received in a cash transaction. In other words, the settlement rate is the implicit rate that equates the cash equivalent exchange price and the ultimate amount after considering the timing of the cash flows.

- If another entity would assume a monetary liability with uncertain terms or purchase and hold a monetary asset (receivable) with uncertain terms either through a trading exchange transaction or a transaction directly with the entity initially recording the asset or liability, the settlement rate is the rate necessary to compensate the other entity for assuming those liabilities or purchasing and holding those receivables. Again, the settlement rate is an implicit rate that equates the current settlement price and the ultimate amount after considering the timing of the cash flows. Many factors affect the price at which the other entity would assume the liability or purchase the receivable.

- Rates of return on risk-free or high-quality fixed-income investments needed to <u>effectively</u> settle a liability (that is, the present value of a liability would equal the sum of money that, if invested currently, would generate the necessary cash flows to settle that liability in the future).

d. Specified rate - An arbitrary rate (for example, a rate prescribed by regulatory authorities).

Views on Selecting a Discount Rate - Liabilities

A. Rate Based On Facts and Circumstances

49. Some believe the different types of monetary liabilities with uncertain terms encountered preclude using any one discount rate and the rate must be based on the unique characteristics of the liabilities being measured. They point out that other areas exist in practice where the accounting application is based on the facts and circumstances of the item. They believe a single discount rate (for example, a borrowing rate) or a specified rate (for example, 8%, prime interest rate) would impair comparability because it would not reflect real differences in facts and circumstances that call for different rates.

B. Lower of Borrowing Rate or Investment Rate

50. Some believe the rate depends on the financial position of the entity, particularly its investment and borrowing opportunities. They would use a discount rate that produces a present value amount that, when compounded by the entity's (1) expected interest rate on borrowings that would

occur if the liability was settled today (opportunity borrowing rate) or (2) in certain cases, an expected rate of return on its existing assets, equals the ultimate liability at maturity. If the entity's actual investment rate is lower than its opportunity borrowing rate, the entity theoretically would not borrow to retain the investment but would use invested assets to settle the liability. In this situation, the discount rate should be the expected rate of return on those existing assets that would be used to settle the liability (actual investment rate). Some entities have no borrowings and use principally invested assets to settle liabilities (for example, insurance enterprises). These entities should use an actual investment rate to discount liabilities. In summary, they believe the discount rate should be the lower of the entity's opportunity borrowing rate or actual investment rate, depending on how the entity would settle the liability at the date the monetary liability with uncertain terms is recorded.

51. They believe this approach yields a better matching of revenue and expenses during the period the liability remains unpaid. They point out FASB 60 requires use of an actual investment rate. In addition, if the discount rate exceeds the entity's actual investment rate, the entity recognizes a loss each period because accretion of the liability will exceed the actual investment earnings of the entity. An additional issue then would be whether those future losses should be recognized currently.

C. Borrowing Rate

52. Others believe a borrowing rate (current market rate) produces amounts that best represent the present value of a liability. Some would use a borrowing rate only when the entity is able to and would borrow to settle the liability at the date the monetary liability with uncertain terms is recorded. Those supporting a borrowing rate believe using an investment rate for discounting liabilities would inappropriately equate the accretion of the liability (expense) with investment earnings. They believe an entity's rate of return is a function of its investment activities and economic conditions during the time the investments are held, and does not relate solely to the period the liability remains outstanding.

53. If an investment rate is used to discount liabilities and that rate exceeds the entity's borrowing rate, they believe discounting would inappropriately recognize future investment income at the date the monetary liability with uncertain terms is recorded because the loss is reduced due to anticipated investment earnings. The future investment income should not be recognized until it is earned. Conversely, if such an investment rate is less than the entity's borrowing rate, they believe the initially recorded present value amount overstates the economic loss and the fair value of the liability.

54. If a borrowing rate is used to discount future cash payments of a financially troubled enterprise, using an extremely high interest rate reflecting the lower credit rating of the enterprise would present the liability at an amount less than that same liability presented by an enterprise that is not financially troubled. They believe the higher discount rate and the smaller discounted liability is appropriate since the counterparty would be willing to settle the liability for a lesser amount because the financially troubled enterprise may not be able to pay the liability in the future.

D. Settlement Rate

55. Some believe the general principle for determining fair value in APB 21 is preferable, "If determinable, the established exchange price (which, presumably, is the same as the price for a cash sale) ... may be used to establish the present value of the note." While APB 21 does not apply to monetary liabilities with uncertain terms, they believe the discount rate should be chosen in a manner similar to that required by APB 21. They would use the rate that when applied to the estimated future cash payments causes the initially recorded present value to equal the amount necessary to settle or effectively settle (see later discussion) the liability currently. The objective is to initially record the fair value of the liability.

56. If a monetary liability with uncertain terms is recorded as the result of an exchange and the exchange price is objectively determinable, the best estimate of the settlement rate generally would be the implicit rate that equates the cash equivalent exchange price and the ultimate payments after considering the timing of the cash flows. If the monetary liability with uncertain terms does not involve an exchange or if an exchange price is not objectively determinable, the settlement rate must be estimated in another manner.

57. In some situations, another entity may be willing to assume a monetary liability with uncertain terms. The entity assuming the liability conceptually would demand funds that it could invest (or use to forego borrowings) to yield sufficient cash to pay the assumed liability at maturity plus a risk related profit. The discount rate normally would be less than the yield because the yield includes a profit element. Many factors affect the price at which the entity would assume the liability. Some would estimate a settlement rate using the rate inherent in the price at which another entity would assume the liability currently if that price is objectively determinable and the liability is capable of being settled currently. Others would estimate a settlement rate in this manner only if the settlement price is reflected in an active market.

58. Those supporting a settlement rate acknowledge that certain monetary liabilities with uncertain terms cannot be settled currently or, if those liabilities are capable of being settled currently, the rate inherent in a current settlement price, as discussed in the preceding two paragraphs, is not objectively determinable. Some believe a settlement rate still can be estimated in these situations and would be the rate inherent in the price at which the liability could be effectively settled currently. That price is defined as the sum of money that, if invested currently, would generate the necessary cash flows to settle the liability in the future. In other words, the initially recorded present value amount is the sum necessary to effectively settle the liability assuming no future changes in the terms of the monetary liability. They believe the objective is to initially record the fair value of the liability. Different investment-type rates might be used to estimate the settlement rate as indicated in paragraphs 70 through 72 in the next section on Investment Rate.

59. Supporters of an effective settlement rate point out FASB Statement No. 87 (FASB 87), "Employers' Accounting for Pensions," provides the following guidance:

> Assumed discount rates shall reflect the rates at which the pension benefits could be effectively settled. It is appropriate in estimating those rates to look to available information about rates implicit in current prices of annuity contracts that could be

> used to effect settlement of the obligation (including information about available annuity rates currently published by the Pension Benefit Guaranty Corporation). In making those estimates, employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits. (Emphasis added)

60. Others believe for those monetary liabilities with uncertain terms that cannot be settled currently or, if those liabilities are capable of being settled currently but the rate inherent in a current settlement price is not objectively determinable, the objective of recording the liability at fair value is not appropriate. Instead, the objective is to record the liability at its present value using one of the following rates:

Borrowing Rate

- Some would use a borrowing rate with the objective of recording the present value of the liability. Others would use the borrowing rate only for those entities that would borrow to settle the liability currently (for example, an insurance enterprise with no borrowings would use an investment rate - see below).

Investment Rate

- Others would use a rate of return on investments that provide cash inflows that approximately coincide with the future cash payments being discounted. Some believe this matching of cash flows is unnecessary. Some would use rates of return on high-quality fixed-income investments; others would use a risk-free rate of return (see the next section on Investment Rate).

61. Supporters of a settlement rate acknowledge there may be more than one settlement rate in a given situation. For example, a company may be able to objectively determine both the price the creditor would have received in a cash transaction and the price at which an independent third party would assume the liability. In addition, the company should be able to estimate the rate at which the company could effectively settle the liability (that is, the sum of money that, when invested, would generate the necessary cash flows to settle the liability when due). Some believe the rate that is more readily determinable should be chosen as an estimate for the settlement rate. Others would look first to the rate inherent in the price the creditor would have received in a

cash transaction, and if not objectively determinable, look next to the rate inherent in the price at which an independent third party would assume the liability. Still others believe the rate chosen should be the "best estimate" of the rate that when applied to the estimated future cash payments causes the present value amount to equal the amount necessary to settle or effectively settle the liability currently (similar to the manner in which rates are chosen to discount pension plan obligations under FASB 87).

62. Some believe a settlement rate determined by using a current settlement price is inappropriate because frequently no settlement transactions are taking place in the market (for example, litigation liabilities). The market is continually changing and to record a discounted liability based on market pricing is not appropriate, particularly for those enterprises not intending or able to enter into a settlement transaction in the market. They point out even when an active market exists, determining the rate necessary to compensate another entity for assuming the liability (that is, a settlement rate) frequently is not evident, particularly when the estimated amounts or payment pattern of future cash payments can vary significantly. The entity that would assume the liability may have significantly different estimates of the amounts or payment pattern of the future claim payments and, if these

different estimates are not known to the entity discounting the liability, could significantly misstate the present value of the liability.

E. Investment Rate

63. Others believe liabilities should be discounted using a rate of return on investments expected to be available during the period the liabilities remain unpaid (opportunity rate) or an actual (imbedded) investment rate. They believe the accretion of the present value amount should match the related investment income. In cases where the entity plans to settle the liabilities with invested assets (instead of borrowing funds), the expected or actual rate of return is the most relevant discount rate. FASB 60 requires the use of an investment rate when discounting the liability for future policy benefits of insurance enterprises.

64. Supporters of an investment rate point out if a borrowing rate is used to discount future cash payments of a financially troubled enterprise, using an extremely high interest rate reflecting the lower credit rating of the enterprise (say, prime plus 8%) would inappropriately present the liability at less than its fair value or current settlement value. The issue then would be whether a maximum discount rate or default rate should be established in such situations.

65. Some believe liabilities should be discounted using a risk-free rate of return on investments expected to be available during the period the liabilities remain unpaid. They believe a portion of an entity's rate of return is a function of its investment activities and economic conditions during the time the investments are held; the other portion reflects the time value of money. If the rate used to discount the liability exceeds a risk-free rate of return, which should be the "minimum" discount rate in all situations, they believe discounting would inappropriately recognize an excessive amount of future investment income, the earning of which is uncertain at the date the liability is recorded. The future investment income in excess of a risk-free rate of return (that is, that portion directly attributable to the entity's investment activities and economic conditions subsequent to the date of the monetary event) should not be recognized until earned.

66. Those supporting a "risk-free" investment opportunity rate define that rate differently. Some believe substantially eliminating default risk is important and would limit risk-free investments to one or any combination of the following:

1. Direct obligations of the U.S. government

2. Obligations guaranteed by the U.S. government

3. Securities that are backed by U.S. government obligations as collateral

67. These investments may be either short-term or long-term with maturities that may or may not extend beyond the estimated payment date of the liability. Some do not believe the matching of the future cash inflows from the investments with the future cash payments being discounted is necessary.

68. Others believe inherent in the risk-free concept is the matching of assured cash inflows and expected cash outflows such that the entity has eliminated substantially all reinvestment risk. Therefore, they support the requirement (as presented in FASB Statement No. 76, "Extinguishment of Debt") that the cash inflows from the investments approximately coincide, as to timing and amount, with the future cash payments being discounted. For example, if an enterprise intends to purchase investments eliminating substantially all risks that cash inflows from the investments would not meet the expected future cash payments, the rate of return on those investments should be the discount rate. That is, the rate being earned on the investments is the "risk-free" rate for the liability because the risks relating to payment of the liability have been eliminated. If the enterprise discounts the liability using this risk-free rate and purchases other than risk-free investments, the risk-related return will be recognized appropriately when earned or lost.

69. Those supporting a risk-free rate of return point out that rate is readily available through the markets, selection of the rate would be less subjective, accounting for the time value of money would be applied consistently and because the "minimum" discount rate is used, future risk-related investment income will be recognized when earned.

70. Some support an investment rate when estimating a settlement rate (see paragraph 58). They believe the risk-free rate generally is the most appropriate estimate for the settlement rate. As previously stated, a settlement rate normally would be less than the yield another entity would earn on the funds obtained in assuming the liability because the yield includes a profit element. Suppose an entity that would assume the liability would invest the funds in high-quality fixed-income investments. In this situation, the discount rate should be less than the rate of return on those investments, but theoretically not less than a risk-free rate. Because of the difficulties in determining the yield (and the related profit element) on funds to be invested by the entity assuming the liability, they believe the risk-free rate is an appropriate estimate for the settlement rate and point out selection of a risk-free rate is objective and readily available. Further, the use of that rate supports the objective of initially recording the liability at fair value.

71. Others supporting an investment rate when estimating a settlement rate (see paragraph 58) believe the rate of return on high-quality fixed-income investments is a more appropriate estimate than a risk-free rate. They point to FASB 87 that states,

> In making those estimates (of discount rates) employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits. (Emphasis added)

72. Those supporting an investment rate other than a risk-free rate of return point out the matching of investment income and accretion of the present value amount normally is not achieved when a risk-free rate is used. Others believe minimizing (instead of substantially eliminating) the default risk (for example, permitting in addition to U.S. government securities, highly rated corporate securities) and the reinvestment risk (for example, requiring the investments only to have the same approximate term as the liability) is desirable. Still others believe the reinvestment risk is more important than the default risk and would use the rate of return on high-quality fixed-income investments that, if owned,

would provide cash inflows that approximately coincide, as to timing and amount, with the expected future cash payments being discounted.

F. Specified Rate

73. Some believe an arbitrary specified rate (for example, 8%, or the prime interest rate) should be used to discount all monetary liabilities with uncertain terms. They believe allowing choices among a number of acceptable discount rates is overly complex and may not be understood by others.

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Advisory Conclusion (Issue 3) - Liabilities

Twelve AcSEC members and three task force members believe that a settlement rate should be used to determine the present value of future cash flows in the initial recognition of monetary liabilities with uncertain terms. The discount rate should be objectively determinable and be the best estimate of the rate at which the monetary liabilities with uncertain terms could be settled or effectively settled. The following should be considered in determining the best estimate of that rate:

- The rate inherent in the price the creditor would have received in a cash transaction at the date the item is recorded.

- If the liability is capable of being settled currently, the rate inherent in the price at which an independent third party (that is, other than the creditor) would assume the liability currently.

- Rates of return on direct obligations of the U.S. government that, if owned, would provide cash inflows that approximately coincide, as to timing and amount, with the expected future cash payments being discounted.

- Rates of return on high-quality fixed-income investments that, if owned, would provide cash inflows that approximately coincide as to timing and amount, with the expected future cash payments being discounted.

Two AcSEC members and two task force members believe that the discount rate should be the rate of return on direct obligations of the U.S. government that, if owned, would

provide inflows that approximately coincide, as to timing and amount, with the expected future cash payments being discounted (that is, a risk-free rate). One AcSEC member believes that the discount rate should be an incremental borrowing rate.

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Views on Selecting a Discount Rate - Assets (Receivables)

A. Rate Based On Facts and Circumstances

74. Those rejecting a single discount rate for liabilities also would support a discount rate for receivables based on the unique characteristics of the item being measured (see prior comments and views for liabilities in paragraph 49).

B. Higher of Borrowing Rate or Investment Rate

75. Those supporting the lower of borrowing rate or investment rate to discount liabilities would use a discount rate that produces a present value amount that, when compounded by the entity's (1) expected rate of return on investments that

would occur if the receivable was collected today (opportunity investment rate) or (2) in certain cases, an expected interest rate on its existing borrowings, equals the ultimate receivable at maturity. If the entity's actual borrowing rate is higher than its opportunity investment rate, the entity theoretically would not invest the funds but would use the funds to pay off existing borrowings. In this situation, the discount rate should be the expected interest rate on those borrowings that would be extinguished. In summary, they believe the discount rate should be the higher of the entity's opportunity investment rate or actual borrowing rate, depending on how the entity would use the funds if received at the date the monetary asset with uncertain terms is recorded. Generally, the same views apply here as for liabilities (see previous comments beginning in paragraph 50).

C. Investment Rate

76. Others believe an investment rate produces amounts that best represent the present value of a receivable. Using a borrowing rate for discounting receivables would inappropriately equate the accretion of the receivable (income) with interest expense. They believe an entity's interest expense is a function of its financing activities and economic

conditions during the time the borrowings are outstanding, and does not relate solely to the period the receivable is outstanding. If a borrowing rate is used to discount receivables and that rate exceeds the entity's investment rate, they believe the initially recorded present value amount understates the economic gain and the fair value of the receivable. Conversely, if such a borrowing rate is less than the entity's investment rate, they believe discounting would inappropriately recognize future investment income at the date the monetary asset with uncertain terms is recorded because the gain is increased due to anticipated investment earnings.

77. Some believe receivables should be discounted using a risk-free rate of return on investments expected to be available during the period the receivables remain uncollected. Generally, the same views apply here as for liabilities (see prior comments on risk-free investment rate beginning in paragraph 65).

D. Settlement (Acceptance) Rate

78. Generally, those supporting a settlement rate for liabilities have the same views here (see prior comments

relating to liabilities). They would use the rate that when applied to the estimated future cash receipts causes the initially recorded present value to equal the amount that would be received if the receivable were sold currently. The objective is to initially record the fair value of the receivable.

79. If a monetary asset with uncertain terms is recorded as the result of an exchange and the exchange price is objectively determinable, the best estimate of the settlement (acceptance) rate generally would be the implicit rate that equates the cash equivalent exchange price and the ultimate receipts after considering the timing of the cash flows. If the monetary asset with uncertain terms does not involve an exchange or if an exchange price is not objectively determinable, the settlement (acceptance) rate must be estimated in another manner.

80. In many situations, another entity would be willing to purchase and hold a monetary asset with uncertain terms. The entity purchasing the receivable conceptually would pay funds today that it could borrow (or obtain by selling invested

assets) such that the yield on the purchased receivable would provide an acceptable risk-related profit. Many factors affect the price at which the entity would purchase the receivable. Some would estimate a settlement rate using the rate inherent in the price at which another entity would pay to purchase the receivable currently if that price is objectively determinable and the receivable is capable of being sold currently. Others would estimate a settlement (acceptance) rate in this manner only if the settlement price is reflected in an active market.

81. Those supporting a settlement rate acknowledge there may be situations when certain monetary assets with uncertain terms cannot be sold currently or, if those assets are capable of being sold currently, the rate inherent in a current acceptance price is not objectively determinable. In these situations, the following discount rates might be used:

Borrowing Rate

- Some would use a borrowing rate with the objective of recording the present value of the receivable. Others would use the borrowing rate only for those entities that would pay off existing borrowings if the receivable was collected currently.

Investment Rate

- Others would use a rate of return on investments that provide cash inflows that approximately coincide with the future cash receipts being discounted. Some believe this matching of cash flows is unnecessary. Some would use a risk-free rate of return, while others would use rates of return on high-quality fixed-income investments.

E. Borrowing Rate

82. Others believe receivables should be discounted using an interest rate on borrowings expected to finance the receivables. They believe, particularly if the entity plans to extinguish borrowings when the receivables are collected, the expected borrowing rate is the most relevant discount rate. In addition, they believe a borrowing rate is a surrogate for a settlement (acceptance) rate (that is, the entity purchasing the receivables would normally finance the purchase through borrowings). They point out that though APB 21 rejected the theory that discounting is unnecessary when the assets' discount rate exceeds the rate on borrowings used to finance the assets, APB 21 does not apply to monetary assets with uncertain terms.

F. Specified Rate

83. Those supporting an arbitrary specified discount rate for liabilities generally hold the same views here, except the specified rate may be different for receivables (for example, rate of return on direct obligations of the U.S. government).

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Advisory Conclusion (Issue 3) - Assets (Receivables)

AcSEC believes (14 yes, 1 no) and all five task force members believe a settlement (acceptance) rate should be used to determine the present value of future cash flows in the initial recognition of monetary assets with uncertain terms. The discount rate should be objectively determinable and be the best estimate of the rate at which the monetary asset with uncertain terms could be sold. The following should be considered in determining the best estimate of that rate:

- The rate inherent in the price the debtor would have paid in a cash transaction at the date the item is recorded.

- If the receivable is capable of being sold currently, the rate inherent in the price at which an independent third party (that is, other than the debtor) would pay to purchase and hold the receivable currently.

- Rates of return on direct obligations of the U.S. government that, if owned, would provide cash inflows that approximately coincide, as to timing and amount, with the expected future cash receipts being discounted.

- Rates of return on high-quality fixed-income investments that, if owned, would provide cash inflows that approximately coincide as to timing and amount, with the expected future cash receipts being discounted.

* * * * * * *

Issue 3A -- Should the discount rate(s) used to determine the present value of future cash flows in the initial recognition of monetary items with uncertain terms (excluding deferred income tax assets and liabilities) be beforetax or aftertax rates?

Discussion

84. Issue 3A addresses assets and liabilities resulting from monetary items with uncertain terms excluding deferred income tax liabilities. The issue of whether beforetax or aftertax rates should be used to discount deferred income tax assets and liabilities is complex, requiring numerous illustrations (see Background and Approach section).

Aftertax Rates

85. Some believe the tax consequences of a monetary item with uncertain terms should be considered when determining a settlement rate at which to record the item. They point out that the rate inherent in the amount of cash (1) a creditor would accept in settlement of the liability today or (2) a third party would demand to assume the liability today would include a consideration of the tax effects on the creditor or third party of doing so. For example, a creditor would accept a sum of money today that, if invested, would generate sufficient aftertax cash flows to equal on the day the liability is due the cash the creditor would receive were the liability paid when due. Using an after-tax discount rate would cause the monetary item to be stated at such an amount.

85a. Supporters of the aftertax rate also point out that the economic gain or loss on the transaction or event that results in recognition of a monetary item with uncertain terms depends on the timing of the tax consequences of the transaction or event. They believe the discount rate used should produce amounts that reflect that timing. To illustrate, a manufacturing company expects to pay $1,210 under a warranty provision in two years and an insurance company expects to pay $1,210 under an automobile insurance policy in two years. The warranty payment is deductible for tax purposes when paid; the insurance claim is deductible for tax purposes when accrued for financial reporting purposes. The economic loss related to the insurance claim is less than the economic loss related to the warranty payment, because the tax benefit of the insurance claim is received earlier than the tax benefit of the warranty payment. The present values of the payments at beforetax and aftertax discount rates are determined as follows:

Present value of $1,210 payable in two years at -	
Beforetax rate (10%)	$1,000
Aftertax rate (6%) (tax rate = 40%)	$1,077

85b. Supporters of the aftertax rate would discount the warranty payment at an aftertax rate, because they believe doing so would produce amounts that best reflect the economic substance of the warranty claim. They would record warranty expense of $1,077, a tax benefit of $431 ($1,210 times 40%, discounted at 6%), resulting in an aftertax economic loss of $646. In addition, they point out that the $1,077 is the sum of money that, if invested today, would generate sufficient aftertax cash flows to pay the $1,210 liability in two years (that is, $1,077 is the effective settlement price) and that the claimant would accept today to settle the claim, as follows:

Sum of money invested today	$1,077
Investment earnings at 10%, net of taxes at 40%	
19X1 ($108 less 40% of $108)	65
19X2 ($114 less 40% of $114)	68
Warranty liability due	$1,210

85c. Supporters of an aftertax rate point out that the sum of money that would have to be invested to pay the insurance claim is $1,000 because the earnings on the invested assets for tax purposes would equal the deductions for tax purposes based on the accretion of the liability, causing no future net effect on taxable income or taxes payable. In this case, the aftertax rate equals the beforetax rate and the effective settlement price is $1,000. The cash flows are as follows:

Sum of money invested today	$1,000
Investment earnings at 10% net of taxes[A]	
19X1	100
19X2	110
Claim liability due	$1,210

[A] Accretion on the liability would offset the investment earnings for tax purposes; eliminating the taxes.

As a result, supporters of an aftertax rate would record a loss on the insurance policy of $1,000, a tax benefit of $400 ($1,210 times 40%, discounted at 10%), resulting in a $600 aftertax loss, compared to a $646 aftertax loss on the warranty liability. They recognize that supporters of the beforetax rate would coincidentally record the aftertax insurance claim loss as $600 by ignoring the timing of the tax consequences of the cash flows. The coincidence would be caused by the beforetax and aftertax rates being equal.

Beforetax Rates

86. Others believe although discounting aftertax cash flows with aftertax discount rates reflects the economics of the transaction or event, current generally accepted accounting principles generally do not permit the accounting for items with tax affects on a net-of-tax basis. While APB 16 requires net-of-tax valuation of assets acquired and liabilities assumed in purchase business combinations, the FASB has proposed to eliminate that requirement in the exposure draft, "Accounting for Income Taxes." Therefore, in determining a discount rate for the warranty payment in the above example, some believe the taxes on investment earnings

should be excluded from the cash flows; thus, leading to a beforetax discount rate. They also point out the tax effects of cash flows generated by monetary assets placed in a trust in an in-substance defeasance transaction are not considered under FASB Statement No. 76, "Extinguishment of Debt."

87. Some believe the discounting process should consider nothing other than the time value of money and the discount rate should bear no relationship to the tax status of the entity or the tax deductibility or taxable nature of the future cash flows. Others believe a requirement to consider tax status of the enterprise and the timing of the tax effects of the future cash flows in the selection of the discount rate would make the discounting process unduly complex. Still others believe the discount rate depends on the rate of return on investments when discounting liabilities, or the borrowing rate when discounting receivables, ignoring the tax effects of the investment income or interest expense.

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Advisory Conclusion (Issue 3A) -- AcSEC and the task force members unanimously believe that the discount rate used to determine the present value of future cash flows in the initial recognition of monetary items with uncertain terms (excluding deferred income tax assets and liabilities) should be a beforetax rate.

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ACCOUNTING SUBSEQUENT TO INITIAL RECOGNITION

88. This issues paper addresses only those monetary assets and liabilities with uncertain terms. Because of the uncertainties in estimating the amounts and timing of future cash flows, changes in the amounts and timing likely will occur subsequent to the initial recognition of the item. Those changes generally are considered "a change in accounting estimate" that APB Opinion No. 20 (APB 20), "Accounting Changes," requires to accounted for in "(a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both." The issue of what rate should be used to discount the gross amount of the change is addressed by Issue 4B. Issue 4A addresses changes in the timing of cash flows occurring subsequent to the initial recording of the monetary item with uncertain terms.

* * * * * * *

Issue 4A -- Assuming the present value of future cash flows is considered in the initial recording of monetary items with uncertain terms, how should changes in the estimates of the timing of cash flows occurring subsequent to the initial recording of those items be reflected in the financial statements?

Arguments

89. Some believe when the timing of cash flows changes the recorded present value amount no longer reflects the most relevant amount, and the changes in the estimates of the payment pattern should be recognized when they occur. They believe changes in timing of cash flows should be accounted for in the same manner as changes in amounts of cash flows (that is, when they occur). The recorded asset or liability should be adjusted to reflect the present value of the estimated future cash flows based on the revised payment pattern at an appropriate discount rate (see Issue 4B). The adjustment should be recorded as a gain or loss in the income statement unless properly capitalizable as part of the cost of an asset. They point out FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Directs Costs of Leases," requires that changes in estimates of prepayments be reflected through a cumulative catch-up adjustment in the financial statements.

90. Some agree with adjusting the recorded asset or liability based on the revised payment pattern but believe any gain or loss as a result of the adjustment should not be recognized immediately. Instead, the gain or loss should be deferred and amortized over future periods or charged to

equity. They point out changes in pension plan obligations and changes in the value of pension plan assets are not recognized as they occur but are recognized systematically and gradually over subsequent periods in accordance with FASB Statement No. 87 (FASB 87), "Employer's Accounting for Pensions."

91. Others believe the recorded amount should not be adjusted if a change in the payment dates results in a gain; a loss would be recognized immediately. They point out life insurance enterprises record liabilities for future policy benefits on a discounted basis. A gain resulting from a revised mortality rate assumption is not recorded until the ultimate payment is made; losses due to changes in mortality rates are recognized in the period the change occurs.

92. Some people believe instead of adjusting the recorded amount in the period the change occurs, the discount rate should be adjusted so that any gain or loss is recognized over the remaining period to the payment dates (see Issue 4B).

* * * * * * *

Advisory Conclusion (Issue 4A) -- AcSEC believes (14 yes, 0 no, 1 abstain) and all five task force members believe that changes in the estimates of the timing of cash flows occurring subsequent to the initial recording of monetary items with

uncertain terms based on new facts should be reflected in the financial statements when they occur by adjusting the recorded present value amounts. AcSEC believes (14 yes, 1 no) and all five task force members believe that the adjustment should be recorded as a gain or loss in the income statement unless properly capitalizable as part of the cost of an asset. One AcSEC member believes any gain or loss not capitalizable should be deferred and amortized over future periods or charged to equity depending on the nature of the monetary items with uncertain terms.

* * * * * * *

Issue 4B -- Assuming the present value of future cash flows is considered in the initial recognition of monetary items with uncertain terms, should changes in the discount rate occurring subsequent to the initial recording of those items be recognized in the financial statements (1) when the change in the discount rate occurs or (2) only if the estimated amounts or timing of the cash flows are subsequently changed, or should the original discount rate be used in all subsequent periods?

Arguments

93. Some believe once the discount rate is used to initially record a monetary item with uncertain terms, that rate should not be changed for subsequent events (that is, the rate should be locked in). They point out APB 21 states that "any subsequent changes in prevailing interest rates should be ignored," and FASB 60 states that "original assumptions shall continue to be used in subsequent accounting periods to determine changes in the liability for future policy benefits . . . unless a premium deficiency exists." The original rate reflects a historical exchange price and changing the discount rate is viewed as approaching fair value accounting, which is not part of the current accounting model (that is, other assets or liabilities are not adjusted for subsequent changes in interest rates). They point out assets and liabilities that are initially recorded using the present value of future cash flows as the measurement attribute (for example, in purchase business combinations, leasing transactions or exchanges of nonmonetary assets) are not marked-to-market when interest rates subsequently change. Some believe changing discount rates would cause volatility in the financial statements that would adversely affect the usefulness of those statements. In addition, those in favor of using an investment rate to discount liabilities believe that no future investment decision or circumstance alters the investment decisions made at the initial recording of the item.

94. Others generally agree with the lock-in principle discussed in the preceding paragraph. However, they would change the discount rate for incremental increases in the estimated amounts of cash flows. To illustrate: Suppose initially a liability of $1,000 (ultimate cash payment) due in five years was discounted using a 10% rate. Subsequently, the estimated ultimate cash payment was changed to $1,500. Supporters of this view would discount $1,000 at 10% (locked in) and the incremental increase ($500) at the current rate. If the estimated amount was decreased to $500, that amount would be discounted at the original discount rate of 10%.

95. If changes of the estimated timing of cash flows occur, some would change the original rate to reflect the new time period. To illustrate: Suppose the above liability was expected to be paid in 19X5 but now will be paid two years later in 19X7. Supporters of this view would discount the liability using the rate that existed when the item was initially recorded that reflects the longer seven-year period (say 11%) instead of the original five-year period. They believe this is consistent with the lock-in concept discussed in the second preceding paragraph.

96. Some believe a change in the discount rate is an event that should be recognized in the financial statements when it occurs. They believe if there is a periodic remeasurement of an item (for example, defined benefit pension liabilities), all revised assumptions, including changes in the discount rate, should be considered in the remeasurement. FASB 87 requires the discount rate to be revised, if necessary, at each date the pension plan assets and obligations are measured. They view a change in the discount rate similar to changes in the amounts or timing of future cash flows that are accounted for as changes in estimates under APB 20. In addition, they point out when an estimated ultimate cash payment is revised based on new facts, including revised estimates of inflation, it is inconsistent to both (1) consider the revised anticipated effects of future price changes and (2) ignore the offsetting effect of the time value of money. Others would change the discount rate only when there is a material change in terms of the discounted item (that is, if either the estimated amount or timing of future cash flows change or both). Some view material changes in the terms as a new transaction or event that justifies a new discount rate. They would not adjust the discounted asset or liability solely because of changes in the rate used to discount the future cash flows. For example, a company records a loss contingency of $100,000 (which is the present value of $120,000 to be paid in the future) related to pending litigation. Next year, after new facts are discovered, the best estimate of the gross liability is determined to be

$2,000,000. Some would use a new rate to discount the estimated gross amount of $2,000,000.

97. Some believe a change in the discount rate is an event that should be recognized in the financial statements when it occurs but would limit the amount of the adjustment in certain situations. For liabilities, the present value amount (using any revised estimates of the amount or timing of future cash flows) should not be adjusted to an amount lower than the present value amount computed using the original discount rate. In other words, changes in the discount rate should be reflected in the financial statements only to the extent that the new discount rate is lower than the original discount rate. Likewise, for assets, changes in the discount rate should be reflected in the financial statements only to the extent that the new discount rate is higher than the original discount rate. Others agree with the concepts discussed in this paragraph but would change the discount rate only when there is a remeasurement. They would not adjust the discounted asset or liability solely because of changes in the interest rates used to discount the future cash flows.

98. Some believe when changes in the amounts or timing of future cash flows occur, the adjustment to the recorded present value amount (particularly if the adjustment represents a gain) should not be recognized immediately but should be spread to

future periods by adjusting the discount rate or using another amortization method. They point out FASB 87 permits the delayed recognition of changes in discount rates. They believe this approach would reduce volatility in the financial statements. Still others believe the adjustment to the recorded present value amount should be charged to a separate component of shareholders' equity and recognized in the income statement when the ultimate cash flows occur.

99. Some believe when an investment rate is chosen to discount liabilities or a borrowing rate is chosen to discount receivables with the objective of achieving a matching of revenue and expenses in periods subsequent to the initial recognition of the monetary item, the discount rate should be revised to meet this objective. The rate would be revised as assets are reinvested, the investment portfolio mix changes, borrowings are refinanced, etc. In these situations, others believe the discount rate should be changed only when (1) the actual investment earnings are less than the accretion of the liability (expense) or (2) the interest expense exceeds the accretion of the receivable (income).

* * * * * * *

Advisory Conclusion (Issue 4B) -- Twelve AcSEC members and two task force members believe that, assuming the present value of future cash flows is considered in the initial recording of monetary items with uncertain terms, changes in the discount rate should not be recognized in the financial statements and the original discount rate should be used in all subsequent periods (that is, locked in). Three AcSEC members and three task force members believe that changes in the discount rate occurring subsequent to the initial recording of the item should be assessed annually and recognized in the financial statements at that time; however, one of those AcSEC members and two of those task force members believe that when an investment is made whose cash inflows approximately coincide with the expected future cash payments, subsequent changes in the selected discount rate should not be recognized in the financial statements and support the lock-in concept.

If the lock-in concept is adopted, AcSEC and the task force believe there are situations where a discount rate other than the rate used in the initial recording of the item may be used, as follows:

1. Based on new facts, for increases in the estimated amounts of future cash flows, the new discount rate would be applied to the incremental increase in the gross amount of future cash flows (AcSEC 10 yes, 5 no; task force 3 yes, 2 no).

2. Based on new facts, for decreases in the estimated amounts of future cash flows, the original discount rate would be applied to the remaining gross amount of future cash flows (AcSEC 12 yes, 3 no; task force 5 yes, 0 no).

3. Significant changes in the amounts or timing of future cash flows such that the changes are deemed to result in a new transaction or event (AcSEC 9 yes, 4 no, 2 abstain; task force 3 yes, 2 no).

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PRESENTATION AND DISCLOSURES

Issue 5 -- Assuming the time value of money is considered in the initial recognition of monetary items with uncertain terms, what is the nature of the accretion of the present value amount?

Arguments

100. Some believe the accretion is always interest expense or income because discounting reflects the time value of money and the time value of money is by definition interest. They point out APB 21 states that "amortization of discount or premium should be reported as interest in the statement of

operations." In addition, they believe such interest expense should be eligible for capitalization under FASB Statement No. 34 (FASB 34), as amended (see Issue 5B).

101. Others believe the nature of the accretion depends on the type of item measured (for example, the accretion of a discounted insurance loss reserve would be claims expense) and the nature of the accretion should be determined on a case-by-case basis. They question reporting interest expense for insurance enterprises that have no existing debt. They also point out accretion of a pension liability is reported as pension cost under FASB 87. If material, the amount and nature of the accretion would be disclosed in the notes to the financial statements (see Issue 5A).

102. Still others believe accretion represents the cost of the time value of money and a separate element in the financial statements should be used and called, for example, "accretion of the present value discount" regardless of the type of the item being measured or the type of discount rate chosen. Some would accept netting the accretion of assets and liabilities. Some view the accretion as akin to interest expense or income but due to the nature of the item (that is, does not represent a cash outlay or a "normal" accrual), they believe separate disclosure on the face of the income statement is preferable

because it would enhance the understandability of the financial statements.

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Advisory Conclusion (Issue 5) -- Eight AcSEC members and one task force member believe that, assuming the present value of future cash flows is considered in the initial recognition of monetary items with uncertain terms, the accretion of the present value amount always should be reflected as interest expense or interest income, as applicable. Seven AcSEC members and four task force members believe that the accretion of the present value amount may be reflected as interest expense or interest income, as applicable, or may be combined with the event that gave rise to the accretion (for example, accretion of a discounted insurance loss reserve would be claims expense), with appropriate disclosure in the notes to the financial statements (see Issue 5A). AcSEC believes (9 yes, 6 no) and the task force believes (2 yes, 3 no) that the accretion may be reflected in a separate line item on the income statement, with an appropriate title such as, "accretion of the present value discount."

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Issue 5A -- Assuming the present value of future cash flows is considered in the initial recognition of monetary items with uncertain terms, what types of disclosure should be made in the financial statements with respect to the application of discounting?

Discussion

103. The task force has identified the following types of disclosure that could be presented in the notes to the financial statements:

1. Accounting policy on discounting.

2. Type of discount rate (that is, risk-free investment rate, incremental borrowing rate).

3. Discount rate or range of discount rates.

4. Estimated gross amounts that were discounted and the related present value amounts.

5. Timing of the future cash flows-

    a. Estimated future cash flows for each of the five years following the balance sheet date, or

b. Average time period used in discounting the amounts.

6. Classification and amount of the accretion

7. Any significant changes in the above disclosures.

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Advisory Conclusion (Issue 5A) - AcSEC believes (11 yes, 2 no, 1 abstain) and all five task force members believe that the types of disclosure listed above should be considered for inclusion in the financial statements for each major type of monetary item with uncertain terms that was discounted when initially recorded. These disclosure recommendations are not intended to override the disclosure requirements in the authoritative accounting literature (for example, paragraph 9 of FASB 5).

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Issue 5B -- Should the accretion of the present value of a liability be eligible for capitalization under FASB Statement No. 34,"Capitalization of Interest Cost"?

Discussion

104. FASB Statement No. 62, "Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants," states that except in certain limited situations "interest earned shall not be offset against interest cost in determining either capitalization rates or limitations on the amount of interest cost to be capitalized ...." Thus, for purposes of this issue, the accretion of the present value of assets and liabilities should not be offset.

Arguments

105. Some believe the accretion of the present value of a liability should be eligible for capitalization under FASB Statement No. 34 (FASB 34). They point out FASB 34 states:

> "interest cost includes interest recognized on obligations having explicit interest rates,[2] interest imputed on certain types of payables in accordance with APB Opinion No. 21, Interest on Receivables and Payables, and interest related to a capital lease determined in accordance with FASB Statement No. 13, Accounting for Leases."

They view the accretion of the present value amount as part of the interest cost defined above.

106. Others believe the accretion of the present value amount should be eligible for capitalization if the liability can be settled currently. They point out FASB 34 states that the amount of interest cost to be capitalized is intended to be that portion of the interest cost incurred that theoretically could have been avoided if expenditures for the assets had not been made. If the discounted liability can be settled currently, the interest cost incurred (that is, the accretion of the present value amount) theoretically can be avoided. They believe if the discounted liability cannot be settled currently, the interest cost theoretically cannot be avoided and the related accretion should not be eligible for capitalization under FASB 34.

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[2] Interest cost on these obligations includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

107. Still others believe the accretion of the present value amount should never be eligible for capitalization under FASB 34 which states the capitalization rate should be "based on the (interest) rates applicable to borrowings outstanding during the period." They view the accretion as an "imputed" interest cost on a present value amount rather than an "incurred" interest cost on a borrowing eligible for capitalization. This imputed cost (that is, the cost of the time value of money) should never be reported as an asset. They point out FASB 87 specifically precludes the interest cost component of net periodic pension cost from being eligible for capitalization.

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Advisory Conclusion (Issue 5B) -- Six AcSEC members and two task force members believe that the accretion of the present value of a monetary liability with uncertain terms should not be eligible for capitalization under FASB Statement No. 34. Five AcSEC members and one task force member believe that the accretion should be eligible for capitalization if the accretion is classified as interest expense (see Issue 5). Two AcSEC members believe that the accretion should be eligible for capitalization if the accretion is classified as interest expense and the liability is capable of being settled currently. One AcSEC member and two task force members believe

that the accretion should be eligible for capitalization regardless of the classification of the accretion.

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ISSUES PAPER ON THE USE AND APPLICATION OF DISCOUNTING IN FINANCIAL REPORTING

Paragraphs 3 and 4 of APB Opinion No. 21

3. Except that paragraph 16 covering statement presentation of discount and premium is applicable in all circumstances, this Opinion is not intended to apply to:

   a. receivables and payables arising from transactions with customers or suppliers in the normal course of business which are due in customary trade terms not exceeding approximately one year;

   b. amounts which do not require repayment in the future, but rather will be applied to the purchase price of the property, goods, or service involved (e.g., deposits or progress

payments on construction contracts, advance payments for acquisition of resources and raw materials, advances to encourage exploration in the extractive industries);

c. amounts intended to provide security for one party to an agreement (e.g., security deposits, retainages on contracts);

d. the customary cash lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money;

e. transactions where interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (e.g., industrial revenue bonds, tax exempt obligations, government guaranteed obligations, income tax settlements); and

f. transactions between parent and subsidiary companies and between subsidiaries of a common parent (footnote reference deleted).

4. This Opinion is also not intended to apply to, and the Board is not presently taking a position (footnote reference deleted) as to the application of the present value measurement (valuation) technique to estimates of contractual or other obligations assumed in connection with sales of property, goods, or service, for example, a warranty for product performance. This Opinion does not alter the accounting for convertible debt securities described in APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.

APPENDIX B

A search of the accounting literature file in the NAARS data base revealed several hundred references to the concept of discounting (present value).

Below are summarized some of the more significant references, grouped by subject matter.

Summaries from APB Opinion 21 are not listed because that document is discussed in depth in the text of this paper. Summaries from audit and accounting guides and technical practice aids also are not listed because those documents, in most cases, merely describe or recommend principles prescribed in other documents. Selected summaries from issues papers and SEC literature are listed, however.

GENERAL

APB Statement No. 4

Prices based on future exchanges are used in several related concepts: present value of future net money receipts, discounted cash flow, (discounted) net realizable value, and value in use. Each indicates that the amount ascribed to the resource is measured by the expected net future money flow related to the resource in its present or expected use by the enterprise, discounted for an interest factor. (Paragraph 70.)

Current selling price and net realizable value differ conceptually, although they may give the same amount under certain conditions: (1) future sales price is expected to be the same as current sales price (or no better estimate of future sales price than current price is available), (2) no future costs are expected, and (3) discounting is ignored. (Paragraph 70, footnote 17.)

Assets acquired in exchanges are measured at the exchange price, that is, at acquisition cost. Money and money claims acquired are measured at their face amount or sometimes at their discounted amount. (Paragraph 181, section M-IA.)

Liabilities are measured at amounts established in the exchanges, usually the amounts to be paid, sometimes discounted. Conceptually, a liability is measured at the amount of cash to be paid discounted to the time the liability is incurred. Most short-term liabilities are simply measured at the amount to be paid. Discounted present values are often used if the obligations require payments at dates that are relatively far in the future. Pension obligations and liabilities under capitalized long-term leases are measured at discounted amounts. Bonds and other long-term liabilities are in effect measured at the discounted amount of the future cash payments for interest and principal. (Paragraph 181, section M-IC.)

Increases in owners' equity are usually measured by (a) the amount of cash received, (b) the discounted present value of money claims received or liabilities canceled, or (c) the fair value of noncash assets received. Decreases in owners' equity are usually measured by (a) the amount of cash paid, (b) the recorded amount of noncash assets transferred, or (c) the discounted present value of liabilities incurred. (Paragraph 182, section M-2.)

Measurement of owners' investments is generally based on the fair value of the assets or the discounted present value of liabilities that are transferred. The market value of stock issued may be used to establish an amount at which to record owners' investments but this amount is only an approximation when the fair value of the assets transferred cannot be measured directly. (Paragraph 182, section M-2.)

APB Opinion 12

Questions have been raised as to the appropriateness of the "interest" method of periodic amortization of discount and expense or premium on debt (i.e., the difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity) over its term. The objective of the interest method is to arrive at a periodic interest cost (including amortization) which will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period. The difference between the periodic interest cost so calculated and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization. (Paragraph 16.)

Statement of Concepts No. 5

Present (or discounted) value of future cash flows. Long-term receivables are reported at their present value (discounted at the implicit or historical rate), which is the present or discounted value of future cash inflows into which an asset is expected to be converted in due course of business less present values of cash outflows necessary to obtain those inflows. Long-term payables are similarly reported at their present value (discounted at the implicit or historical rate), which is the present or discounted value of future cash outflows expected to be required to satisfy the liability in due course of business. (Paragraph 67.)

Statement of Concepts No. 6

Unamortized or deferred debt discount belongs to the first group (paragraph 231) and was long commonly reported as an asset and amortized to interest expense by straight-line methods. APB Opinion No. 21, Interest on Receivables and Payables, changed that practice by requiring debt discount to be (a) deducted di-

rectly from the liability (as a "valuation account") and (b) "amortized" by the "interest" method using the effective interest or discount rate implicit in the borrowing transaction. That accounting reports the liability at the present value of the future cash payments for interest and maturity amount, discounted at the effective rate (which is higher than the nominal rate specified in the debt agreement), and reports interest expense at an amount determined by applying the effective rate to the amount of the liability at the beginning of the period. (Paragraph 235.)

AGRIBUSINESS

SOP 85-3

Some accountants argue that the investment in a cooperative is in substance a long-term investment and, as such, should be carried at cost or at cost plus allocated equities. Others believe that the investments should be discounted to their present value. The carrying amounts would be adjusted downward as required by generally accepted accounting principles when the patron becomes unable to recover the full carrying amounts. (Paragraph 96.)

Those that support discounting of investments in cooperatives to present value believe that it results in satisfactory presentation in the financial statements because allocated equities are usually not redeemed or are redeemed over a long period... Proponents of the stated amount method also believe that it produces symmetry, since the investee records the issuance of securities or book credits at par or face amounts rather than on the basis of discounted values. They argue further that the method conforms with the underlying price-adjustment theory of cooperatives, which holds that such allocated equities are merely reductions of the cost of supply purchases or increases in the proceeds of products marketed through the cooperative... (Paragraph 97.)

BANKING, THRIFTS, AND MORTGAGE BANKING

SAB No. 42

The staff believes that the standards set forth in paragraph 7 of FASB Interpretation No. 9 for valuing the deposits of a savings and loan association are appropriate for other financial institutions. The fair value of such liabilities is the present value of the amounts to be paid using prevailing interest rates for similar deposits at the acquisition date. (Response to Question 2.)

The lives of identifiable intangible assets are often closely related to other assets acquired or liabilities assumed. For example, an intangible asset whose fair value is the present value of expected earnings from mortgage escrow deposits should be amortized over the estimated life of the related mortgage

investments; an amortization method should be used which reflects the decreasing escrow levels resulting from expected payoffs of the mortgage loans. An intangible asset whose fair value is the present value of expected net interest margins to be earned from other purchased deposits normally should be amortized on an accelerated basis over a period which reflects the pattern of the expected runoff of the related deposits. (Response to Question 3.)

FASB Statement No. 65

The amount capitalized as the right to service mortgage loans shall not exceed the amount by which the present value of estimated future servicing revenue exceeds the present value of expected future servicing costs... The rate used to determine the present value shall be an appropriate long-term interest rate. (Paragraph 18.)

BONDS AND OTHER OBLIGATIONS

APB Opinion 26

Reacquisition price of debt is the amount paid on early extinguishment, including a call premium and miscellaneous costs of reacquisition. If early extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities. (Paragraph 3.)

FASB Statement No. 47

Disclosure of the amount of imputed interest necessary to reduce the unconditional purchase obligation(s) to present value is encouraged but not required. The discount rate shall be the effective initial interest rate of the borrowings that financed the facility (or facilities) that will provide the contracted goods or services, if known by the purchaser. If not, the discount rate shall be the purchaser's incremental borrowing rate at the date the obligation is entered into. (Paragraph 8.)

FASB Statement No. 88

The cost of termination benefits recognized as a liability and a loss shall include the amount of any lump-sum payments and the present value of any expected future payments. (Paragraph 15.)

FASB Technical Bulletin 85-2

The expected residual interest in the collateral should be computed using the present value of all amounts expected to revert to the issuer or its affiliates (including reinvestment earnings). Excess (above-normal) servicing fees should be considered to be part of the expected residual interest. (Paragraph 2, footnote 5.)

BUSINESS COMBINATIONS

APB Opinion 16

An asset acquired by exchanging cash or other assets is recorded at cost - that is, at the amount of cash disbursed or the fair value of other assets distributed.

An asset acquired by incurring liabilities is recorded at cost - that is, at the present value of the amounts to be paid. (Paragraph 67.)

General guides for assigning amounts to the individual assets acquired and liabilities assumed, except goodwill, are...

Receivables at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary.

Accounts and notes payable, long-term debt, and other claims payable at present values of amounts to be paid determined at appropriate current interest rates.

Liabilities and accruals - for example, accruals for pension cost, warranties, vacation pay, deferred compensation - at present values of amounts to be paid determined at appropriate current interest rates.

Other liabilities and commitments, including unfavorable leases, contracts, and commitments and plant closing expense incident to the acquisition, at present values of amounts to be paid determined at appropriate current interest rates.

An acquiring corporation should record periodically as a part of income the accrual of interest on assets and liabilities recorded at acquisition date the discounted values of amounts to be received or paid. (Paragraph 88.)

FASB Statement No. 38

Some respondents to the Exposure Draft inquired whether it would be appropriate to base the amount recorded on the present value of the amount determined in accordance with the criteria in paragraph 5(b) because the nature of the resulting amount would be a monetary asset or liability. The Board concluded that it should not specify such a requirement because the timing of payment or receipt of a contingent item seldom would be sufficiently determinable to permit the use of a present value technique on a reasonable basis. However, this Statement does not prohibit the use of a present value if appropriate. (Paragraph 33.)

FASB Statement No. 33

Net present value of expected future cash flows. Assets are measured at the present value of expected future cash inflows into which the asset is expected to be converted in due course of business less the present value of expected future cash outflows necessary to obtain those inflows. This measurement of an asset is often described as value in use. (Paragraph 99.)

Current cost represents a conservative measure of the net present value of future cash flows because net present value represents the maximum price at which purchase of an asset would be worthwhile. (Paragraph 120.)

Some Board members concluded that the measurement of assets at current cost or lower recoverable amount could provide a useful basis for assessing future cash flows to the enterprise because those measurements can be regarded as surrogates for the net present value of cash flows expected to be earned from the use of assets. Current costs may presumably be expected to have some relationship to net present values (and hence future cash flows) because estimated net present value will represent the maximum sum that an enterprise would be willing to pay for an asset. The exact nature of the relationship will depend on conditions in the markets in which the assets are bought and sold. Measurements of assets at their recoverable amounts represent direct estimates of the net present values of future cash flows (in the case of values in use) or approximations to net present values (in the case of net realizable values). (Paragraph 133.)

FASB Statement No. 89

Recoverable amount is the current worth of the net amount of cash expected to be recoverable from the use or sale of an asset. It may be measured by considering the **value in use** or **current market value** of the assets concerned. Value in use is used to determine recoverable amount of an asset if immediate sale of the asset is not intended. Current market value is used to determine recoverable amount only if the asset is about to be sold. (Paragraph 29.)

Value in use. The amount determined by discounting the future cash flows (including the ultimate proceeds of disposal) expected to be derived from the use of an asset at an appropriate rate that allows for the risk of the activities concerned. (Paragraph 44.)

IASC Statement No. 15

The current cost approach is found in a number of different methods. In general, these use replacement cost as the primary measurement basis. If, however, replacement cost is higher than

both net realizable value and present value, the higher of the net realizable value and present value is usually used as the measurement basis. (Paragraph 11.)

The replacement cost of a specific asset is normally derived from the current acquisition cost of a similar asset, new or used, or of an equivalent productive capacity or service potential. Net realizable value usually represents the net current selling price of the asset. Present value represents a current estimate of future net receipts attributable to the asset, appropriately discounted. (Paragraph 12.)

COMPENSATED ABSENCES

Statement No. 43

Some respondents requested guidance on how an employer should estimate its liability for compensated absences. The respondents asked (a) whether the liability should be based on current or on future rates of pay, (b) whether it should be discounted, and (c) when the effect of scheduled increases should be accrued. The Board noted that it expects to be studying similar issues in its project on accounting by employers for pensions as well as in a possible project on discounting and, accordingly, concluded to defer a decision on such issues at this time. (Paragraph 20.)

DEFERRED COMPENSATION

APB Opinion 12

The amounts to be accrued periodically should result in an accrued amount at the end of the term of active employment which is not less than the then present value of the estimated payments to be made. (Paragraph 6, footnote 1.)

DEPRECIATION

Issues Paper on Depreciation of Income Producing Real Estate

The economic analysis of an investment in income producing real estate is similar to the analysis of other long term investment; it focuses on cash flow and the discounted amount of future cash flows expected to accrue to the equity investor. (Paragraph 5.)

Under the annuity method, annual depreciation is a fixed amount that represents the rent of an ordinary annuity whose present value at the assumed interest rate and for the term of the asset's life is equal to the asset's depreciable base. The annual depreciation charge is offset each period by reporting imputed interest on the carrying amount of the asset as income and as a reduction of the accumulated allowance for depreciation. (Appendix D.)

EMPLOYEE STOCK COMPENSATION PLANS

Issues Paper on Employee Capital Accumulation Plans

Discounted amount approaches -- These are approaches that use the above approaches adjusted for the time value of money, that is, allocation of the discounted amount of the total amount of the component related to the plans of the acquisition cost or fair value of services received. The approaches are known as discounted mark-to-market, and so forth. The major argument in support of the discounted amount approaches is that they recognize that a period of time will elapse before the events involved in the plan have all occurred. Proponents of these approaches argue that a more representative amount will appear on the balance sheet if it is reported at the discounted amount rather than at the gross amount that will be finally determined. In addition, they argue that these approaches have additional applicability with stock appreciation rights when cash will be paid at the end of the exercise period. Others argue, however, that cash is often not involved and therefore discounted amount consideration should be ignored. Also, these approaches reduce compensation expense, which many believe cause (sic) be an understatement. Finally, others note that these approaches are cumbersome and lead to many subjective evaluations, such as selection of the interest rate and exercise period. (Paragraph 186.)

IMPAIRMENT OF VALUE

Issues Paper on Accounting for the Inability to Fully Recover the Carrying Amounts of Long Lived Assets

There are too many difficulties in determining the amount at which a long lived asset should be reported, including inaccuracies inherent in forecasting future cash flows, the arbitrariness of ascribing revenue to a particular long lived asset, and the subjectivity of applying a discount rate to future cash flows. (Paragraph 18.)

The inaccuracies inherent in forecasting future cash flows, the arbitrariness of ascribing revenue to particular long lived asset, and the subjectivity of applying a discount rate to the cash flows may preclude presentation in the accounts, but the possible effects, if material, should be disclosed. (Paragraph 22.)

INCOME TAXES

APB Opinion 10

The Board is presently giving attention to this general subject with a view to issuing an Opinion on it. One of the questions now being considered is whether certain long-term tax allocation accounts should be determined on a discounted basis as recommended in the Study. Pending further consideration of this subject and the broader aspects of discounting as it is related

to financial accounting in general and until the Board reaches a conclusion on this subject, it is the Board's opinion that, except for applications existing on the exposure date of this Opinion (September 26, 1966) with respect to transactions consummated prior to that date, deferred taxes should not be accounted for on a discounted basis. (Paragraph 6.)

APB Opinion 11

The Board's Opinion on "Tax Allocation Accounts--Discounting," as expressed in APB Opinion No. 10, Omnibus Opinion--1966 (paragraph 6), continues in effect pending further study of the broader aspects of discounting as it is related to financial accounting in general. (Paragraph 3.)

INSURANCE

SEC Codification of Financial Reporting Policies

A column has been added to Rule 12-18 to provide for the disclosure of the aggregate discounts deducted from the reserves for the registrant and consolidated subsidiaries, for unconsolidated subsidiaries, and for 50%-or-less-owned equity investees. A footnote to the schedule requires disclosure of the rate, or range of rates, estimated if necessary, at which the discount was computed for each category. A provision calling for disclosure of the effects of discounting in the aggregate has been retained in Part 2(B)(5) of the Guide. (Section 403.04.d.)

Issues Paper on Key Person Life Insurance

However, under the death benefit approach the level annual deposit would not be based on cash surrender value at the end of the measurement period, but would be related to the present value of the expected death benefit as of the key-person's expected retirement date. The anticipated date of death would be based on life expectancy or mortality factors. After retirement, the present value of the projected death benefit would be increased annually at the assumed interest rate. (Paragraph 38.)

FASB Statement No. 60

Premiums from long-duration contracts shall be recognized as revenue when due from policyholders... The present value of estimated future policy benefits to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders (liability for future policy benefits) shall be accrued when premium revenue is recognized. Those estimates shall be based on assumptions, such as estimates of expected investment yields, mortality, morbidity, terminations, and expenses, applicable at the time the insurance contracts are made. (Paragraph 10.)

Liability for future policy benefits - An accrued obligation to policyholders that relates to insured events, such as death or disability. The liability for future policy benefits can be viewed as either (a) the present value of future benefits to be paid to or on behalf of policyholders and expenses less the present value of future net premiums payable under the insurance contracts or (b) the accumulated amount of net premiums already collected less the accumulated amount of benefits and expenses already paid to or on behalf of policyholders. (Glossary.)

Issues Paper on Computation of Premium Deficiencies

The recognition of the time value of money in the computation of premium deficiencies is considered in this issues paper as it relates to the method of determining the existence of and accounting for a deficiency. The Committee believes that the issues of discounting claims and the recognition of the time value of money in the computation of premium deficiencies should be addressed separately. (Paragraph 8.)

Issues Paper on Stock Life Insurance

When the premium revenue is recognized, a liability is accrued for future policy benefits under the contract. The liability for future policy benefits (often referred to as the benefit reserve) is determined as follows:

Present value of future benefits to be paid
- Present value of future net premiums
= Liability for future policy benefits.

The "net premium" used in this calculation is the portion of the gross premium payment that is needed to provide for the cost of all expected benefits and expenses. (Paragraph 32.)

The interest rate used in calculating the present values is based on the insurance company's expected investment yields at the time the contract is entered. (Paragraph 33.)

Acquisition costs are capitalized and expensed in relation to premium revenues; so the entire acquisition cost will be expensed at the inception of the contract. When the premium revenue is recognized, the liability for future policy benefits is accrued. The liability is the present value of future benefits minus the present value of future net premiums. Since there are no future premiums in a single-premium product, the liability for future benefits simply equals the present value of the future benefits. (Paragraph 40.)

The present value of future benefits is determined using the company's expected investment yield as the basis for the interest rate. The liability will grow each period by that rate, and an expense will be accrued. (Paragraph 41.)

INTANGIBLES

APB Opinion 17

Intangible assets acquired singly should be recorded at cost at date of acquisition. Cost is measured by the amount of cash disbursed, the fair value of other assets distributed, the present value of amount to be paid for liabilities incurred, or the fair value of consideration received for stock issued as described in paragraph 67 of APB Opinion No. 16. (Paragraph 25.)

LEASES

Discounting (present value) principles transcend all of lease accounting, which is discussed in 10 FASB Statements, 6 FASB Interpretations, and 9 FASB Technical Bulletins. The references to the discounting principles discussed in the area of leases are too numerous to mention here.

LEASE BROKERS

Issues Paper on Lease Brokers

For the service of bringing together a lessor and a lessee and arranging the lease (brokerage service), lease brokers generally record as income the total cash fee plus the present value of the rights to the estimated residual value when the brokerage service is provided (at the beginning of the initial lease term). (Paragraph 14.)

Money-over-money transactions are generally accounted for as brokerage transactions, that is, the excess of the cash received from third party financiers or lessees over the cost of the assets leased is recorded as fee income at the beginning of the lease term. Any residual value retained is generally discounted and also recorded as fee income at the inception of the initial lease term. However, some account for money-over-money transactions as leases, recognizing the excess cash received in income over the lease term. (Paragraph 16.)

If the present value of the estimated residual or other future value is recorded at the time the brokerage transaction is completed (at the beginning of the initial lease term), various rates are used in practice to discount the future values, such as the lease broker's incremental borrowing rate, the rate of the nonrecourse debt associated with the transaction, or the rate implicit in the lease. (Paragraph 23.)

If the fees paid in the form of rights to the residual value are recorded at present value, practice varies as to whether lease brokers accrete that value to the full estimated residual value over the term of the lease. Some lease brokers accrete to full value over the lease term, while others recognize at the end of the lease term a gain or loss equal to the difference between the residual value share realized at the end of the initial lease

term and the original present value of the estimated residual value. (Paragraph 24.)

FASB Technical Bulletin No. 86-2

An enterprise acquiring an interest in the residual value of any leased asset, irrespective of the classification of the related lease by the lessor, should not recognize increases to the asset's estimated value over the remaining term of the related lease, and the asset should be reported at no more than its acquisition cost until sale or disposition. (Paragraph 6.)

A lessor retaining an interest in the residual value of the leased asset should not recognize increases in the value of the lease residual to its estimated value over the remaining lease term. (Paragraph 10.)

LOSS CONTINGENCIES

Issues Paper on Medical Malpractice Loss Contingencies

The relevant accounting literature provides no guidance on whether unpaid malpractice claims should be recorded at the estimated ultimate cost of settlement or at the present value of anticipated future cash payments. Because of the substantial time lag that generally exists between the date the claim is incurred and the date the claim is paid, the difference between valuing unpaid claims (accrued asserted and unasserted claims) at the estimated ultimate cost of settlement and a discounted amount is significant. (Paragraph 32.)

The AICPA Insurance Companies Committee has been working for several years on an issues paper on discounting property and liability claims. Pending completion of that project this issues paper does not take a separate position on the issue of discounting. Accordingly, until the discounting issue is resolved, health care providers that discount accrued malpractice claims should disclose in the notes to their financial statements the carrying amount of accrued malpractice claims that are presented at present value in the financial statements and the range of interest rates used to discount those claims (see FASB Statement No. 60, paragraph 60(d)). (Paragraph 44.)

MOTION PICTURES, FILMS, AND BROADCASTERS

FASB Statement No. 53

The amount of the license fee for each film ordinarily is specified in the contract, and the present value of that amount, computed in accordance with the provisions of APB Opinion No. 21, Interest on Receivables and Payables, generally shall be used as the sales price for each film. (Paragraph 9.)

FASB Statement No. 63

A licensee shall report the asset and liability for a broadcast license agreement either (a) at the present value of the liability calculated in accordance with the provisions of APB Opinion No. 21, Interest on Receivables and Payables, or (b) at the gross amount of the liability. If the present value approach is used, the difference between the gross and net liability shall be accounted for as interest in accordance with Opinion 21. (Paragraph 4.)

OIL AND GAS

FASB Statement No. 69

A standardized measure of discounted future net cash flows relating to an enterprise's interests in (a) proved oil and gas reserves (paragraph 10) and (b) oil and gas subject to purchase under long-term supply, purchase, or similar agreements and contracts in which the enterprise participates in the operation of the properties on which the oil or gas is located or otherwise serves as the producer of those reserves (paragraph 13) shall be disclosed as of the end of the year. (Paragraph 30.)

SEC Regulation 210.4-.10

Limitation on capitalized costs: (i) For each cost center, capitalized costs, less accumulated amortization and related deferred income taxes, shall not exceed an amount (the cost center ceiling) equal to the sum of: (A) The present value of future net revenues from estimated production of proved oil and gas reserves as defined in paragraph (k)(6) of this section; plus (B) the cost of properties not being amortized pursuant to paragraph (i)(3)(ii) of this section; plus (C) the lower of cost or estimated fair value of unproved properties included in the costs being amortized; less (D) income tax effects related to differences between the book and tax basis of the properties involved.

(ii) If unamortized costs capitalized within a cost center, less related deferred income taxes, exceed the cost center ceiling, the excess shall be charged to expense and separately disclosed during the period in which the excess occurs. Amounts thus required to be written off shall not be reinstated for any subsequent increase in the cost center ceiling. (Paragraph (i) (4).)

Disclosure of future net revenues from estimated production of proved oil and gas reserves. In conjunction with the disclosure of changes in net quantities of estimated proved reserves of crude oil (including condensate and natural gas liquids) and natural gas as required by paragraph (k)(5) of this section, the following information shall be disclosed in financial statements for each geographic classification for which quantities of oil and gas are disclosed:

(ii) The present value of the Estimated Future Net Revenues (the "Present Value of Estimated Future Net Revenues"), as of the end of each fiscal year for which an income statement is required, computed using a discount factor of ten percent, for each of the categories for which Estimated Future Net Revenues are disclosed pursuant to paragraph (k)(6)(i) of this section. (Paragraph (k) (6).)

PENSION COSTS

Discounting (present value) principles transcend all of pension accounting, primarily APB Opinion 9 and FASB Statements No. 87 and 88. The references to the discounting principles discussed in the area of pensions are too numerous to summarize here.

PENSION PLANS

FASB Statement No. 35

Plan investments, whether equity or debt securities, real estate, or other (excluding contracts with insurance companies) shall be presented at their fair value at the reporting date. The fair value of an investment is the amount that the plan could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than a forced liquidation sale. Fair value shall be measured by the market price if there is an active market for the investment. If there is not an active market for the investment but there is such a market for similar investments, selling prices in that market may be helpful in estimating fair value. If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided the expected cash flows are discounted at a rate commensurate with the risk involved. (Paragraph 11.)

The primary information regarding participants' accumulated plan benefits reported in plan financial statements will be their actuarial present value. This Statement defines participants' accumulated plan benefits as those future benefit payments that are attributable under the plan's provisions to employees' service rendered to the benefit information date. Their measurement primarily based on employees' history of pay and service and other appropriate factors as of that date. Future salary changes are not considered. Future years of service are considered only in determining employees' expected eligibility for particular types of benefits, for example, early retirement, death, and disability benefits. To measure their actuarial present value, assumptions are used to adjust those accumulated plan benefits to reflect the time value of money (through discounts for interest) and the probability of payment (by means of decrements such as for death, disability, withdrawal, or retirement) between the

benefit information date and the expected date of payment. (Summary.)

PERSONAL FINANCIAL STATEMENTS

SOP 82-1

Recent transactions involving similar assets and liabilities in similar circumstances ordinarily provide a satisfactory basis for determining the estimated current value of an asset and the estimated current amount of a liability. If recent sales information is unavailable, other methods that may be used... include the use of discounted amounts of projected cash receipts and payments. (Paragraph 13.)

Personal financial statements should present receivables at the discounted amount of cash the person estimates will be collected, using appropriate interest rates at the date of the financial statements. (Paragraph 16.)

Several procedures or combinations of procedures may be used to determine the estimated current value of a closely held business, including a multiple of earnings, liquidation value, reproduction value, appraisals, discounted amounts of projected cash receipts and payments, or adjustments of book value or cost of the person's share of the equity of the business. (Paragraph 23.)

Intangible assets should be presented at the discounted amounts of projected cash receipts and payments arising from the planned use or sale of the assets if both the amounts and timing can be reasonable estimated. (Paragraph 25.)

Personal financial statements should present payables and other liabilities at the discounted amounts of cash to be paid. The discount rate should be the rate implicit in the transaction in which the debt was incurred. If, however, the debtor is able to discharge the debt currently at a lower amount, the debt should be presented at the lower amount. (Paragraph 27.)

REAL ESTATE

FASB Statement No. 66

The present value of the specified rental payments is the present value of the lease payments specified in the lease over the term of the primary indebtedness, if any, on the improvements, or over the customary amortization term of primary debt instruments on the type of improvements involved. The present value is computed at an interest rate appropriate for (a) primary debt if the lease is not subordinated or (b) secondary debt if the lease is subordinated to loans with prior liens. (Footnote 15.)

The net receivable is discounted to the present value of the payments required. The present value is determined using an appropriate interest rate, not less than the rate stated in the sales contract. The objective is to value the net receivable at the amount at which is could be sold without recourse to the seller at the date of the sales contract. (Paragraph 70.)

If there is an obligation for future improvement costs that is recognized under the percentage-of-completion method:

...

b. Unrecoverable costs of off-site improvements, utilities, and amenities are provided for. In determining the amount of unrecoverable costs, estimates of amounts to be recovered from future sale of the improvements, utilities, and amenities are discounted to present value as of the date the net unrecoverable costs are recognized. (Paragraph 75.)

REGULATED ENTERPRISES

FASB Statement No. 71

The regulator's action provides reasonable assurance of the existence of an asset (paragraph 9). Accordingly, the regulated enterprise would capitalize the cost and amortize it over the period during which it will be allowed for ratemaking purposes. That cost would not be recorded at discounted present value. If the amounts are material, the disclosures specified in paragraph 20 of this Statement would be furnished. (Paragraph 34.)

FASB Statement No. 90

Any disallowance of all or part of the cost of the abandoned plant that is both probable and reasonably estimable, as those terms are used in Statement 5 and Interpretation 14, shall be recognized as a loss. The present value of the future revenues expected to be provided to recover the allowable cost of that abandoned plant and return on investment, if any, shall be reported as a separate new asset. Any excess of the remainder of the cost of the abandoned plant over that present value also shall be recognized as a loss. The discount rate used to compute the present value shall be the enterprise's incremental borrowing rate, that is, the rate that the enterprise would have to pay to borrow an equivalent amount for a period equal to the recovery period. In determining the present value of expected future revenues, the enterprise shall consider such matters as (1) the probable time period before such recovery is expected to begin and (2) the probable time period over which recovery is expected to be provided. If the estimate of either period is a range, the guidance of Interpretation 14 shall be applied to determine the loss to be recognized. Accordingly, the most likely period within that range shall be used to compute the present value. If no period within that range is a better estimate than any other, the

present value shall be based on the minimum time period within that range. (Paragraph 3.)

The recorded amount of the new asset shall be adjusted from time to time as necessary if new information indicates that the estimates used to record the separate new asset have changed. Those estimates include (a) the determination of whether full return on investment will be provided and, if not, the probable time period before recovery is expected to begin and the probable time period over which recovery is expected to be provided and (b) the amount of any probable and reasonably estimable disallowance of recorded costs of the abandoned plant. The amount of the adjustment shall be recognized in income as a loss or gain. Paragraphs 21, 22, and 24 of Appendix A illustrate how this paragraph applies to changes in the estimated time period before recovery begins and the time period over which recovery is expected to be provided. The recorded carrying amount of the new asset shall not be adjusted for changes in the enterprise's incremental borrowing rate. (Paragraph 4.)

RESTRUCTURED DEBT

Issues Paper on In Substance a Repossession or Foreclosure

The fair value may be determined by discounting cash flows at a rate commensurate with the risk involved, and the provision required in anticipation of foreclosure would exceed significantly in many instances that based on the net realizable value computations using average cost of capital. (Page 1.)

FASB Statement No. 15

The carrying amount of a receivable encompasses not only unamortized premium, discount, acquisition costs, and the like but also an allowance for uncollectible amounts and other "valuation" accounts, if any. A loss on transferring receivables to creditors may therefore have wholly or partially recognized in measuring net income before the transfer and be wholly or partly a reduction of a valuation account rather than a gain or loss in measuring net income for the period of the transfer. (Footnote 7.)

A debtor in a troubled debt restructuring involving only modification of terms of a payable--that is, not involving a transfer of assets or grant of an equity interest-- shall account for the effects of the restructuring prospectively from the time of restructuring, and shall not change the carrying amount of the payable at the time of the restructuring unless the carrying amount exceeds the total future cash payments specified by the new terms. That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount shall be reflected in future periods. Interest expense shall be computed in a way that a constant effective interest rate is applied to the carrying amount of the

payable at the beginning of each period between restructuring and maturity (in substance the "interest" method prescribed by paragraph 15 of APB Opinion No. 21). The new effective interest rate shall be the discount rate that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable. (Paragraph 16.)